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Book Reviews

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The Journal of SOCIAL, POLITICAL AND ECONOMIC STUDIES

Roger Pearson
General Editor
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CONTENTS

The Future of European Missile Defense Systems
Sydney Orman 387

The People's Republic of China Confronts Taiwan
James H. Hughes 401

Arab Political Organizations within the Israeli State
Adham Saouli 443

Attracting Capital Portfolio Inflows: National and Political Attributes of Energing Markets
Shah M. Tarzi 461

The Limits of Social Justice
Miles D. Wolpin 481

Book Reviews
Why Smart People Make Big Money Mistakes – and How to Correct Them: Lessons from the New Science of Behavioral Economics; MAGIC: The Untold Story of U.S. Intelligence and the Evacuation of Japanese Residents from the West Coast during WW II; Irrational Exuberance 502

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The Future of European Missile Defense Systems

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Gaithersburg, Maryland

The reasons for the lack of interest of European allies in missile defense are reviewed. It is concluded that although previous analyses have indicated that there has been no desire to invest in such systems, a number of external triggering events have occurred which should cause them to re-examine their policies. The new Bush Administration appears ready to provide the necessary positive leadership and assistance required to draw European allies into a regional missile defense. Without agreeing to cooperate in such activities it is likely that the security policy of the European nations acting individually, or even cohesively outside of NATO, could become so severely constrained that Europe would cease to be a major force in international affairs.

Key Words: Missile Defense, BMD, ABM Treaty, Bush Administration, Europe, Russia, Israel

Broad Perspective

For the past 18 years Ballistic Missile Defense, BMD, has been a contentious subject. If there is to be any real progress from deterrence towards a more balanced offense/defense form of security, it will be essential to look back with the clarity of vision that comes from hindsight, and try to understand why BMD still remains so unpopular. Nearly sixty years have passed since cruise & ballistic missiles were used against Britain in World War 2 [1], yet most governments remain opposed to the deployment of effective missile defenses.

There are alleged to be several interconnected reasons why missile defenses remain undesired in so many quarters. The most prominent amongst these are; a refusal by most nations to acknowledge a threat, an uncertainty of the quality of the technology to counter the threat, an unwillingness to allocate significant extra resources to new defense programs, and concern at the possible effect of BMD on arms control

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treaties and agreements [2]. Some of these reasons are mutually exclusive, but that has not prevented their repeated use by advocates of arms control, who vigorously oppose investment in even purely defensive military equipment.

The Threat

A review of the facts underlying the disparagement of BMD, suggests that some of the claims against missile defense may be built on emotional rather than logical thought. For example, it is suggested that possession of a capability without clear hostile intent cannot be equated with a threat, even though it becomes more difficult to sustain this attitude as the well documented proliferation of offensive capabilities continues to be recorded [3]. Ballistic missiles (BMs), cruise missiles (CMs), remotely piloted vehicles (RPVs) and warheads of mass destruction (WMDs) are already in the arsenals of several nations, with a growing risk they could eventually become accessible to terrorist organizations. These systems have provided previously quite minor countries with the capability to threaten other nations well beyond their own borders.

Although possessors claim that the acquisition of these offensive systems provides them with deterrence against hostile actions, their possession also enables coercion of others in their region, and even the ability to modify the policies of more distant countries. Much more powerful nations could be intimidated if they have no defensive capability against missiles with a range to reach their centers of population. It is these issues that has finally forced NATO to acknowledge a threat, and will now force consideration of some form of missile defense on the proponents of the European Rapid Reaction Force, ERRF. In the absence of such protection the force could be rendered so vulnerable, as to be undeployable.

Status of Defensive Technology

The American program that has been pursued for 18 years under the SDIO and later the BMDO leadership provides a reference point for the status of the technology. Despite the hype that accompanied the start of the Strategic Defense Initiative, few really believed in 1983 that a defense sufficiently effective to provide national security against a massive Soviet nuclear missile attack could be achieved. Nonetheless the concept of non-nuclear interception was given a significant boost, and far greater support from Congress, after the successful intercept of

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a Minuteman missile booster in the Homing Overlay Experiment in June 1984 [4]. This provided proof that a threat missile could be destroyed in flight by a defensive missile without the use of any warhead. Previously all defensive missile designs had carried nuclear warheads.

In the seventeen years since the successful intercept over the Pacific, the program has made many other significant technical advances; for example, repeatedly demonstrating lethality with hit-to kill technology (Pac 3 and THAAD), and with fuzed explosive warheads (Navy Area System). It has demonstrated enhanced seeker technology, adaptive optics for lasers, and cooperative engagement capabilities, introducing real system-of-system possibilities. In addition computing capabilities have improved beyond recognition, enabling missiles to undertake tasks that would have occupied a control center full of equipment a few short years ago. Yet despite these major successes a genuine American missile defense system has yet to be brought into service [4]. This is particularly unfortunate in terms of the earlier predictions of how quickly, and inexpensively such systems could be provided. Those predictions may well have contributed towards the fall of the Soviet Union, thereby more than justifying the investment in BMD, but they also led to a culture in which R&D optimism totally overwhelmed acquisition realism [5].

Despite the development of these impressive technical capabilities, it is clear that the lack of a consistent goal, coupled with a neglect of attention to system engineering, has significantly delayed the acquisition of a defense. While Reagan was in office the program enjoyed high priority, but this declined after his departure. During the Clinton Administrations the impression given was that NMD complicated other foreign policy objectives. Russia [6] and China [7] have consistently opposed the program and have made no secret of their strong objections to it's continuation. Possibly as a result of their opposition, linkages have been established between NMD deployment and other international issues, making BMD as a whole something of a political football [8]. This has led to regular changes of priority in the American program, greatly complicating the management task, resulting in lengthening of timescales and increasing costs.

Defense Investment

Since the end of the Cold War the European investment in defense has been significantly less than America's as a percentage of

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GDP. With the pie getting smaller, each individual military service in European countries has fought hard to retain their traditional role in equipment replacement and enhancement programs. In this environment BMD, as a multi service or purple activity, has lacked a champion. Without strong political support, there has been no military pressure in individual European countries for investment in BMD. Even if new money were to be provided, without very strong civilian control, the danger remains that it would be dissipated in a reassessment of more traditional individual Service programs.

A further factor which has made allies reluctant to get too involved, is the observation that America has invested more than $60B in BMD activities, without as yet deploying even the first elements of a defense. The reasons for this inefficiency may be apparent to those who study the details of the subject, but to political leaders the message is clear. BMD is still too complex and too expensive to undertake. None seem to have learned from the Israeli example in which the government, strongly supported by their population, identified the threat, and took action to counter it. Israel concentrated its' efforts on a specific program and was able to start deployment of the Arrow/Green Pine system in late 2000. Israel has thus become the first nation to deploy a non-nuclear BMD, and has demonstrated that missile defense is achievable and affordable [9].

Arms Control & The ABM Treaty

The Soviets, succeeded by Russia have been the sole possessors of a strategic nuclear missile defense for over 25 years. That defense, although not nation wide, has been credited with the ability to protect a significantly greater area than just Moscow. The defense was considered to be sufficiently effective in the late 1970s to cause America, Britain & France to invest heavily in upgrading their offensive deterrent systems [10]. Yet throughout the Cold War, and since, the Soviet/Russian strategic defense was not considered destablizing. In sharp contrast, the Congressional passage of a National Missile Defense Act in 1999, quite predictably led Russia, China and many other countries to voice strident opposition to the American proposals. They claimed that deployment of an NMD would destroy the strategic balance, and lead to a new arms race. These strong objections were based on the fact that the American NMD was designed to protect all 50 States, albeit only from a very limited attack. The fact that the whole nation could receive some limited protection would contravene the

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restrictions of the ABM Treaty, which was specifically designed to prohibit national defense against missile attack. It is the undermining of the Treaty which underlies so much of the opposition to BMD.

The Reagan Administration spent some time attempting to reinterpret the 1972 Treaty, in an effort to enable a defense to be deployed without totally undermining the arms control agreements linked to the Treaty. Those efforts were unsuccessful, but they revealed all too clearly that an effective population defense could not be deployed within the constraints of the existing Treaty. So it was hardly surprising that attempts throughout the eight years of the two Clinton Administrations, to negotiate modifications with Russia to allow the deployment of a limited NMD, all failed. The attempts were rebuffed, even though it was clear that any defense which America could deploy in the foreseeable future, would be ineffective against a massive Russian attack.

President Bush has now made clear his recognition of the dramatic changes in the world security situation that has made the Treaty irrelevant. Nations have to take account of the tens of countries, including many "states of concern" (that we used to call rogue nations), with small arsenals of missiles [3]. The foreign policy of America and it's allies could be modified by even the threat of attack, if no defense against these missiles is deployed. The Cold War theories of deterrence may not apply to those nations that have recently acquired missiles, and a defense would provide a back up against miscalculation. It should not be forgotten that the ABM Treaty attempted to limit the number of offensive missiles each side was acquiring during the Cold War. It did not prevent an overwhelming build up of nuclear tipped missiles then, and it should not prevent defenses now against the proliferated threat.

The Present Position

Four years ago in an attempt to analyze why the well documented proliferation of missile capabilities had failed to modify the opposition to BMD, the present authors identified six factors which influence national attitudes towards the implementation of major new defense programs [11]. These were a recognition of the threat, a military requirement to counter the threat, public and government support for the policy, the technical capability, financial commitment and the ability to proceed under national and international treaties. A detailed examination of each factor led to the award of a score in which a

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higher mark represented a greater interest. Subjectively it was assumed that a democratic country would have to get a total mark above 75%, to be able to move forward with a new program. Even after passage of the 1999 Missile Defense Act, the score assessed for America fell short of the required level and that assessed for Europe was below 20% [12].

In retrospect one additional factor was omitted from the analysis. That was an external triggering event that would overwhelm the more ponderous review that normally proceeds decisions in democratic societies. Four such major international triggering events have occurred in recent months which are likely to have a significant effect on European attitudes towards BMD. These are:-

1. The American intention to proceed with an NMD[13,14],
2. The EU decision to proceed with the ERRF [15],
3. The Russian offer on European BMD [16], and
4. The Israeli deployment of Arrow [9].

Together they ensure that the subject of BMD has been raised again to Cabinet level consideration in all European countries, and will remain there for the foreseeable future.

The most critical triggering event has been the expressed resolve of the Bush Administration, spelt out clearly in the President's speech at the National Defense University to proceed with an NMD [14]. (NMD is an expression which is being phased out to be replaced by the more generic term of missile defense). Allies that have sheltered under U.S extended deterrence for over 40 years are being forced to re-evaluate their own security. These allies had shown considerable alarm in 1999 with the passage of the Congressional Act, but had been somewhat relieved when in signing the Act, President Clinton had added four, extra criteria of his own [16]. These were; the level of the threat, technical viability, the cost, and the effect on international arms control. The last criterion reassured both friends and potential adversaries. It was taken as code wording for retention of the ABM Treaty, which his Administration had repeatedly claimed to be the cornerstone of international security. The criteria suggested that while the Democrats controlled the White House there would be no deployment of an NMD. The actions of President Bush since his election has totally changed the scenario. The allies are likely to come to the conclusion that BMD will proceed, with or without them. At the time of writing American briefing teams have been visiting capitals, but have yet to

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overcome the long held concerns that the deployment of a missile defense will undermine the strategic balance and initiate another arms race [17].

Although the formation of the ERRF has been the subject of critical comment, as a potential source of conflict with NATO [18,19,20], it's formation is proceeding and provides another triggering event that will force European nations to re-evaluate BMD. There can no longer be any question of sending troops to a crisis area without protection against missile attack. However in addition to protection of the ERRF, European nations will have to be resistant to coercion from whomever is causing the crisis. Merely by sending troops into a troubled area could open European capitals to the threat of attack. When faced with this, governments will have difficulty explaining why America, that is geographically distant from likely crisis areas has an NMD, while European capitals will continue to rely on deterrence and the threat of retaliation. The very fact of providing the ERRF with a BMD will open Pandora's Box.

The Russian offer to cooperate with Europe on the development of a BMD represents another major change. In so doing they have tacitly acknowledged that a third world missile threat to Europe does exist. It was noted earlier that the Soviets/Russia have had their own strategic defense for over 25 years. During that time there have been numerous allegations that their system was not fully compliant with the ABM Treaty. Those allegations have not inhibited the Russians from objecting to American plans for an NMD, on the very same grounds; namely that the American system would not comply with the Treaty. The Russians have suggested that the U.S. does not face a threat from emerging nations, and furthermore, the proposed system although of limited scope, would be inadmissible because it would be capable of intercepting a small scale attack aimed at any State of the Union. The inference being that the Russian defense, although substantial is not nationwide and therefore not destablizing, while the American one would be. Only after it became apparent that the Russian opposition was unlikely to influence the Bush Administration, were proposals made for cooperation on BMD in Europe, and for further discussions on a balance of offensive/defensive forces with the U.S. The mere fact that Russia now acknowledges that emerging nations do represent a real threat, should alone should force European governments to re-examine their own views of security.

The final recent international trigger has been the announcement

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that Israel has deployed a purpose built missile defense based on the Arrow missile and the Green Pine radar. Unlike all the other nations reviewed, Israel have had no doubt about the threat they faced since observing the Iran/Iraq war in 1988. During that conflict some 240 missiles were used, some possibly incorporating chemical warheads [21]. Had Israel still retained any doubt, that was quickly removed during the Desert Storm war in 1991, when Iraqi Scuds were fired at them and Saudi. They saw the danger 13 years ago and reacted accordingly. They have now become the first nation to deploy a non-nuclear BMD, and perhaps more importantly have demonstrated that missile defense is advisable, affordable and achievable.

Hardware Availability

Despite consistent and prolonged efforts by successive American Administrations to persuade European allies to cooperate in BMD programs, there has been little real success. The only joint development program currently in progress, the Medium Extended Air Defense System, MEADS, involving America, Germany and Italy has had a checkered history. The system was conceived to provide a tactically mobile defense against cruise and short range ballistic missiles. Like Pac-3 it would provide only localized defense, but in this case for a mobile force. Cost, and technical transfer problems have recurred repeatedly, jeopardizing the future of the program. The ongoing problems inevitably cast severe doubt on the wisdom of embarking on future such international joint development efforts between America and European allies [21].

The European country which has invested most in independent activity in missile defense has been France. This is somewhat ironic since France, unlike Britain, Germany, and Italy, did not sign an SDI MOU in the 1985/86 timeframe. Agreements that were pursued at that time by the Reagan government as a means of enhancing allied interest in BMD. It is also no secret that the French would prefer greater European independence from American influences in defense, and they indeed have been the principal proponents of the ERRF. The French have been developing Aster, an interceptor missile, and will no doubt offer it as a means of providing the ERRF with a Pac 3-type capability. The Aster will be deployed later this year in a Naval variant, and a ground launched form is due to follow [22]. The Aster is claimed to be effective against aircraft, cruise missiles, and 600 km range ballistic missiles. Design work has been started, funded only by Matra as an

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independent venture, to enhance the capability to intercept 1500 km range ballistic missiles. The success of flight trials indicates it may be possible to eliminate the warhead and produce a true Hit-to-Kill, HTK, capability at 15 to 25 km altitudes.

The French will support the Aster with the Arabel radar system, but the British, who will also deploy the Naval variant of Aster, will utilize their own Sampson radar. This latter radar has proven digital adaptive beam forming and anti-jamming capabilities, which would appear to offer significantly enhanced performance over other systems currently in production [22] .

Spain, Germany and the Netherlands are acquiring new Frigates and have kept open the options to incorporate the theater ballistic missile systems currently under development for the US Navy for theater wide and for area defense needs. Combining these European capabilities could produce the first elements of a European lower tier BMD system. A start, but still a long way from a fully effective TMD, needed for the ERRF.

Because of the publicity given initially to the SDI program and then later to NMD, much more emphasis has been given worldwide to defense against BMs as compared to cruise missiles, CMs. Intelligence reports however indicate that CMs are likely to become the offensive system of choice, in the future. Their proliferation will be more difficult to control because of the commonality of many of their subsystems with aircraft, coupled with the fact that they will be much cheaper to acquire and to operate than BMs. Furthermore, they have the capability of carrying significant payloads, and are particularly suited for chemical and biological delivery; the so called poor nations warheads of mass destruction [23].

It is fortuitous therefore that the lower tier American and French interception systems entering service this year are more capable of engaging CMs than the longer range BMs. The latter are fortunately unlikely to become a threat to Europe for a few more years. The major problem still to be overcome for effective cruise missile defense is better early detection and tracking of low flying CMs. An improvement in sensors will be needed, which when integrated with, the American early warning systems should enable Pac-3, Aster, and the Naval systems to be capable of defending against CMs as well as short range BMs. MEADS, which will incorporate the Pac 3 missile, will also provide defense against these systems, in a tactically mobile form.

Despite these advances, an upper tier system will be required to

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provide adequate troop protection against the longer range threat systems which are expected in the future, and for any form of population defense. Herein lies a significant problem, because America will not have such a system until 2007 at the earliest, while Europe has nothing at all in the development pipeline.

The American Theater High Altitude Area Defense system, THAAD, has not had a smooth development history, and despite efforts which are underway to get it into service earlier than 2007, there is as yet no evidence that this can be achieved [24]. Furthermore it will be some considerable time after it first appears with the US Army before sufficient numbers could be produced to enable it to be acquired by allies, if indeed allies decided such a design would meet their needs. So regardless of political decisions that may be made in the near future, there is no prospect of European nations deploying an effective TMD against longer range ballistic missiles much before 2010.

Key Issues For Europe

While European nations have done their best to ignore the possibilities of BMD, their security situation has been changed by conditions outside of their control. They hoped to rely on Treaties and agreements to prevent proliferation of missile and unconventional warhead technology, but are now being forced to acknowledge this has not been successful. Too many countries are in the process of acquiring capabilities which will enable them to coerce, threaten, or even attack European centers of population. Deterrence through the threat of nuclear retaliation, that prevailed throughout the Cold War, has too many uncertainties for this new multipolar world. The freedom to pursue foreign policy in an uninhibited framework has always been dependent upon the ability to defend the homeland, and in this new environment, policy independence will require the acquisition of BMD

The American offer to allies to participate in BMD activities appeared initially to be represent an opportunity to cooperate on the acquisition of assets required for a European RMD. It seemed unlikely that it could be interpreted as an invitation to try to modify the U.S. decision to proceed with the NMD program. However the meetings held in allied and other capitals during May, indicated that the Americans were still willing to listen to advice, because they had not yet come to any firm conclusions [17]. The principal benefit that America can offer to Europe at this juncture is leadership. A firm policy, coupled with the provision of guidance on the assets required for an RMD, and

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assistance with the acquisition of those assets which cannot be procured within European resources.

Without debating the merits of the different architectures that are being proposed for the American NMD, it is evident that several subsystems could be common between the NMD and those required for an RMD. Early warning, accurate tracking and discrimination capabilities, upper and lower tier interceptors, and an integrated battle management system are obvious examples. The manner in which these are identified and their acquisition shared between the allies will greatly influence attitudes towards a new policy that will have to evolve on both sides of the Atlantic.

America has already agreed to share early warning data on launches of theater-range BMs with friends and allies, as a means of engendering greater cooperation. This arrangement should be formalized to provide the basis for a much broader agreement which would ensure that the data on any launch could be used effectively as basic input to localized nodes of an RMD, and would be constantly available. This would provide a highly cost effective way of utilizing the very significant investment America has made, and continues to make, in early warning and tracking capabilities.

In previous articles it has been postulated that a system as complex as NMD will require several years of enhancement, even after initial deployment [25]. The same will undoubtedly be true for a European RMD, or if governments are willing to look even further ahead, for a GMD. Thus whatever capabilities European nations agree to acquire in the short term for the ERRF will have to be viewed merely as the start of a more comprehensive system. Compatibility with American TMD and NMD will be an essential requirement, together with a modular architecture for the battle management system to enable further enhancements and expansions to be made, as growth of the threat demands, or technology improvements permit.

An obvious conclusion is that a start should be made as soon as possible on the acquisition of the initial elements of a European TMD, so that the complex issues that will have to be faced in developing this rudimentary system into a more effective regional defense, can be seen in perspective. The open question that remains is whether or not European governments are finally willing to confront these issues and move forward. Not too much confidence can be placed in the fact that NATO is just in the process of awarding contracts for industry to conduct an 18 month study on an active layered BMD [26]. The

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possibility remains that this will become yet another BMD study in a series that have been undertaken by NATO and individual European countries over a period of 14 years. None of these earlier activities have lead to any decision to invest. At the worst this new study will join the others in a large filing cabinet, at the best it could delay any major decision for a further 2 years, or more.

European nations will be aware that a decision to participate in active BMD will necessitate full defense reviews, as Rumsfeld is now leading in the DOD. It would not be possible to initiate the major changes in programs and defense doctrines needed, without a thorough re-examination of present commitments. Traditionally European leaders avoid conducting such detailed defense reviews, preferring instead to make minor changes in future planned programs. As an example, a German-American analysis of BMD published in January 2001, while reaching similar conclusions to those presented herein, failed to even mention the broader implications [27]. Considerations such as these suggest that despite the overwhelming evidence supporting the need for early decisions, European governments may continue to delay, hopefully not until an attack removes all doubt that a threat really exists.

On a more optimistic note, there appears to be growing awareness that the old security rules no longer apply. Far fewer leaders now dispute that the world strategic security situation has changed drastically since the fall of the Former Soviet Union. The new Bush administration has made it clear that European NATO allies can no longer expect to shelter solely under the umbrella of American extended nuclear deterrence. America is working towards a more balanced posture between offense and defense. It is now up to European governments to follow along a similar path. This is the route to ensure that the vital NATO alliance remains strong and cohesive. To modify a phrase from a popular film, "build it or they will come".

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THE ABM TREATY CHARADE:
A Study in Elite Illusion and Delusion
William T. Lee
Former CIA and DIA analyst of Soviet and U.S. missile programs

CONTENTS

Foreword by William R. Graham; Acronyms and Designators; Personalities; "Arms Control" Illusions and Realities; FSU ABM Programs from World War II to 1968; Initial Development of the Moscow ABM System; Initial Stages of NABM Development; ABM Nuclear Warhead Development; 1967 - Crisis in Soviet ABM Programs; Lacunae in the Russian Records; U.S. ABM Programs in the 1960s; The SALT ERA; Sacrificing U.S. ABM on the Altar of MAD; Modernizing Moscow's Defenses; Modernizing NABM; Other FSU Strategic Defensive Programs; "Arms Control" of Strategic Ballistic Missiles; The ABM Treaty and The Real Brink of Nuclear War; Gorbachev, and the Demise of the Empire; Corroboration of LPARs As Battle Management Radars; Dual Purpose Design of the SA-10; Transforming "SAMs" into Regional ABMs; Verification of "Arms Control" Agreements; ABM Treaty Violations; Violations of Strategic Offensive Force Agreements; The Current U.S. Predicament; START II; Conclusions.

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The People's Republic of China Confronts Taiwan

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The author examines the Chinese military threat to Taiwan and after a brief historical synopsis proceeds to assess PRC preparations for a possible invasion of Taiwan, detailing the technology and resources available for a PRC assault and Taiwanese resistance.

Key Words: China, PRC, Taiwan, Taiwan Strait, military strength.

Taiwan is located in a position of great strategic importance. During World War II the island was used as a staging area for Japan's invasion of the Philippines, Indochina, and the Dutch East Indies, and as a base for Japanese kamikaze attacks against U.S. naval forces operating off Luzon island in the Philippines.

It sits astride the Taiwan Strait, one of the most heavily traveled sea lanes in the world, and consequently lies across Japan's lifeline of oil from the Middle East. An independent Taiwan is therefore important to Japan,[1] and Taiwan has sought closer ties to its former master.[2] However, Japan's post-World War II Constitution severely restricts the size of its military, with current defense expenditures running at only around one percent of its Gross Domestic Product (GDP), compared with U.S. expenditures which are close to three percent of GDP. Significantly, however, Japan's new prime minister, the popular Junichiro Koizumi elected in May 2001, favors a stronger military and closer ties with the United States.[3] He has shown a favorable attitude toward Taiwan and, in spite of China's opposition, supported former Taiwan President Lee Teng-hui's application for a Japanese visa.[4]

U.S. policy toward Taiwan takes into consideration the importance of a free Taiwan to Japan,[5] as also to New Zealand and Australia, which latter has strong trading ties with Japan, exporting much of its iron and natural resources to Japan.[6]

Taiwan is of strategic importance to another key U.S. ally, South Korea. Referring to the mutual trade relations and common bonds of

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democracy which link South Korea, Taiwan and Japan, Taiwan's Vice President Annette Lu has proposed the formation of a Northeast Asian alliance between the three countries.[7]

But Taiwan's strategic geographical position is also of interest to the People's Republic of China (PRC), since to China it is a door to the Philippines and the western Pacific, with its vast ocean expanse dotted with islands – including Guam and the Northern Mariana Islands. But while Beijing sees Taiwan as a door opening on to the western Pacific, the United States sees it as an outpost of democracy, and has maintained strong historical ties with its government. During the Korean War, when the U.S. military were openly confronted by Chinese troops fighting alongside the North Koreans, the United States interposed its 7th Fleet in the Taiwan Strait to discourage any possible Chinese attack on Taiwan, while providing military and economic aid to Taiwan, and in 1954 it signed a mutual defense treaty with Taiwan. This remained in force until 1978, when the U.S. government decided to recognize the PRC, but even since then the U.S. has not failed to recognize the strategic value of Taiwan.[8] A free Taiwan has immense strategic value for the United States.

The Historic Background

Taiwan was a thinly populated island, largely unsettled, until Western European nations began to use it in the late 1500's and 1600's as an entry port into China. China was aware of Taiwan's existence since around the 3rd century A.D., but did not settle it. Starting from the late 1500's, the Portuguese, Dutch, Spanish, and French ruled or occupied parts of Taiwan intermittently. The Portuguese were first in 1590, naming the island Ilha Formosa (the Beautiful Island).

Beginning in the 1600's, Chinese from nearby coastal provinces began to migrate to Taiwan to work as laborers, or to flee famines and wars in China. Chinese and Japanese pirates also used the island. In 1662, the half-Japanese, half-Chinese pirate Cheng Cheng-kung, also known as Koxinga, overthrew the Dutch. A loyalist to the Ming dynasty, he used Taiwan as a base of opposition against the newly installed Ching (Manchu) dynasty that had just defeated the Ming dynasty.

By 1683, Taiwan had fallen to the control of the Ching (Manchu) Emperors. It then became a county of Fujian (Fukien) province. There followed a period of about two hundred years, from the 1680's through 1894, during which China attempted to impose its rule on

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Taiwan, but frequent insurrections and rebellions meant that Taiwan remained only under nominal Chinese control.

Thus. Taiwan was never a province of China until the late 1880's when the decaying Manchu dynasty, in an attempt to forestall Japan's second expansion southward down the Ryukyu Island chain, declared Taiwan to be a Chinese province. Facing conflict over competing claims to Taiwan and Korea, China and Japan came to blows in the Sino-Japanese War of 1894-1895. Humiliated and defeated by Japan, in 1895 China ceded Taiwan under the terms of the Treaty of Shimonoseki.

From 1895 through 1945, Japan ruled Taiwan, putting down the Taiwan Republic that was briefly set up in 1895. While Japanese occupation was harsh, Japan improved Taiwan's infrastructure of roads, trains, agriculture, and hydroelectric power, laying the foundation for much of Taiwan's future economic growth. China, however, did not forget its claims to Taiwan.

During World War II, China pressed its claim for ownership of Taiwan at the Cairo Conference of 1943 with the "big three" of Churchill, Roosevelt, and Stalin. The big three agreed to Chiang Kai-shek's request as head of the Chinese Nationalist government that Taiwan be "returned to China." The agreement to assign Taiwan to China, once Japan had been defeated, was made without Taiwan's approval, an apparent violation of the Atlantic Charter which held that territorial changes should be in accord with the freely expressed wishes of the people concerned.[9] Approval of Chiang Kai-shek's request was, however, understandable. The "big three" were focused on Hitler, and President Roosevelt, seeing China as an important ally in the war against Japan, was sympathetic to Chiang's request.

On October 25, 1945, therefore, Taiwan was turned over to Chiang Kai-shek's Nationalist troops. First welcomed by the Taiwanese as liberators from Japanese rule, the Chinese Nationalists (Kuomintang) quickly lost popularity as they sought to essentially maintain Japanese colonial institutions – substituting Chinese mainlanders for Japanese. When in early 1947 the Taiwanese middle class demanded more influence, the Nationalists responded with a massive policy of repression. Thousands of Taiwanese intellectuals and professionals were arrested, imprisoned, or simply disappeared, and thirty years passed before a new generation of Taiwanese political leaders emerged and Taiwanese resentment subsided.

In 1949, following the defeat of the Chinese Nationalists by the

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People's Liberation Army led by Mao Tse Tung, Chiang Kai-shek retreated to Taiwan with a million and a half Chinese Nationalists. There they imposed martial law over the next four decades, maintaining their rule by tight control of the police, military, media, and political and educational systems, even though they made up only 15 percent of Taiwan's population.

In 1952 the San Francisco Peace Treaty formally concluding World War II with Japan was signed. In that treaty Japan formally conceded sovereignty over Taiwan, but the treaty did not return Taiwan to China, now ruled by the PRC. Instead it concluded that ". . . the future status of Taiwan will be decided in accord with the purposes and principles of the Charter of the United Nations."[10] As Article 1.2 of the United Nations Charter states that one of its purposes is "To develop friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples . . . ," the treaty left Taiwan to determine its own future.

But Taiwan did not declare independence from China after the San Francisco Peace Treaty. The Nationalists considered that they were still the legitimate leaders of The Republic of China (ROC), even though they controlled only Taiwan. Indeed, they represented China in the United Nations, and claimed to represent all the Mainland Chinese who were now under Communist rule, The Republic of China being the name adopted under Sun Yat Sen following the overthrow of Imperial rule and the introduction of a system of elected government in China in 1911. The Chinese Nationalists believed they would someday return to China to supplant the Communists, and seeing Taiwan as the legitimate heir to Sun Yat Sen's Republic of China, insisted that Taiwan was a part of China – the question of independence *from* China simply did not arise.

Under Chinese Nationalist rule, Taiwan made substantial economic and political progress. Following Chiang Kai-shek's death in 1975, control passed to his son, Chiang Ching-kuo who pursued a policy of political liberalization that transformed Taiwan into the vibrant democracy that it is today. In 1987 martial law was lifted, and the formation of political parties outside the KMT (Kuomintang or Chinese Nationalist Party) was allowed.

Chiang Ching-kuo also took steps to integrate native Taiwanese into local political office, and opened the KMT party to native Taiwanese and mainland Chinese Nationalists alike. In line with opening the KMT to native Taiwanese, Chiang mentored and promoted

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a Taiwanese university professor, Lee Teng-hui, to various high offices, culminating in Lee's appointment as Vice-President.

Following Chiang Ching-kuo's death in 1988, Lee Teng-hui became President. Lee continued Chiang's process of democratization. In 1996, in Taiwan's first presidential election, Lee Teng-hui ran for president in a multi-party election and won. But immediately prior to the election, the PRC chose to fire ballistic missiles close to Taiwan in a show of force, being particularly riled when Lee visited his *Alma Mater*, Cornell University, and publicly suggested that the PRC should negotiate with Taiwan on a "special state-to-state basis."

Marking Taiwan's political progress, in March 2000, in a three way race, Chen Shui-bian led the Democratic Progressive Party (DPP) to victory in the election for president. Former President Lee Teng-hui, well into his seventies, did not run. The DPP advocated independence for Taiwan, and promised to check the corruption (popularly known as "black gold")[11] associated with the KMT following a public scandal over the purchase of six Lafayette class frigates from France involving kickbacks and the murder of Taiwanese naval Captain Yin Ching-feng.[12] This side of the KMT stemmed from its past association with Chinese warlords during the struggle against Communism on the mainland.

The election of Chen Shui-bian as president marked the transition of Taiwan into a full-fledged, modern democracy. Taking office in May 2000, Chen Shui-bian, keenly aware of the PRC's threat to attack to Taiwan if it declared independence, tempered his pro-independence stance to reduce the risk of war. As a gesture of goodwill, in January 2001 Chen Shui-bian initiated the three "mini-links" of mail, trade, and tourism between the Chinese mainland and offshore Taiwanese islands of Kinmen and Matsu.[13]

For its part, the PRC rebuffs Chen's offers to negotiate and continues its arms buildup across the Strait.[14] The PRC occasionally signals that it is willing to negotiate. But the PRC is preparing for war. It is pursuing an aggressive campaign of diplomacy to isolate Taiwan. It seeks to create division within Taiwan by promoting "friendship" with Chen Shui-bian's political opponents, the Kuomintang (KMT) and People First Party (PFP).[15] The PRC's pretensions alarmed even PFP Chairman James Soong to warn a group of PFP legislators visiting China to be "careful" of not being used by Beijing.[16]

Taiwan's Defense

Taiwan's defense hinges on its air power. It has focused on

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building a modern air force to repel a Chinese invasion and air and naval attacks. Its air force consists primarily of jet fighters, which may be used as fighter-bombers. It does not have heavy bombers.

Taiwan's air force is comprised of 130 new IDFs (Indigenously Designed Fighters), 146 U.S. F-16As, 58 French Mirage 2000-5s, and 144 upgraded F-5E/Fs which are used primarily for training.[17] In April 20001 Taiwan brought its Mirages into full operational service, and it plans to bring its F-16s into full service in February 2002.[18] It also has four E2-T AWACS aircraft.[19]

Besides its air force, Taiwan's air defense system includes ground-based radar, like the top secret Sungshan radar station on top of Taipei's Yangmingshan mountain, 1000 meters high, which is one of four control and reporting centers for its air defense network. Under the control of the Air Force's anti-aircraft operations center in Kungkuan, Taipei, the Sungshan radar station monitors and identifies aircraft, and provides real time information. It is one of five radar stations the PRC threatened to destroy with missiles in 1996. It is protected by three batteries of Patriots deployed around Taipei.[20]

In 2000 the United States approved the sale to Taiwan of an AN/FPS-115 PAVE PAWS radar with over-the-horizon capability, which would give Taiwan the ability to view the PRC's interior aircraft movements and ballistic missile launches.[21] But this radar is as yet only in the process of being purchased. It was sold as a compromise to the sale of the Aegis radar to which the PRC objected.

Taiwan's jet fighters are equipped with Sparrow, Sidewinder, and Magic (for Mirages) air-to-air missiles. Taiwan has also produced its own air-to-air missile, the Sky Sword II also called the Tien Chien II or TC-2, which has its own radar seeker. This is reputed to be similar to the U.S. AIM-120 (AMRAAM).[22]

The TC-II has a longer range than the AIM-120, but in 2000 Taiwan purchased 200 AIM-120Cs, which are still considered superior because of their lighter, more powerful rocket thruster and accurate homing electronics. Taiwanese pilots have test-fired the AIM-120 but the AIM-120s are being stored in the United States because of a requirement that the PRC first deploy the AA-12 (R-77) surface-to-air missile it purchased from Russia, which it apparently has since done.[23]

Taiwan's air force has air-to-ground weapons such as Harpoon and Maverick. In 2001 it is taking delivery of a new batch of Mavericks, improving Taiwan's ability to threaten nearby targets in the PRC as part of its deterrent.[24] In 2000 Taiwan purchased 48 AN/ALQ-184

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electronic countermeasure pods and 39 Pathfinder/Sharpshooter navigation and targeting pods for its F-16s.[25]

Along with air-to-ground weapons Taiwan has developed the TC-2A from the Sky Sword II missile. This is an anti-radiation missile which will have an expected range of 74 km to 90 km and can be used for counter-attacking the PRC's air defense radar stations along its southeastern coast.[26]

Taiwan's air force is deployed over a handful of air bases. Its IDFs are based at the Ching Chuan Kang air base in Taichung and the Tainan air base on the islands low lying western coastal plain: a small number are occasionally deployed offshore in the Penghu islands. Its Mirages are based at Hsinchu on the northwest coast. Its F-16s are based at Chiayi and Hualien in the east. Its F-5E/Fs are based at Taitung.[27]

While Taiwan's air bases, radar stations, naval bases and other major military facilities are mostly unhardened and vulnerable to air attack, the Chiashan air base at Hualien on the east side was hollowed out of a mountain, as was the Chihhang air base at Taitung, a smaller version of the Chiashan base. These bases on the eastern part of the island, part of the "Chienan" project, were designed to preserve the air force from an attack by the PRC.[28]

To improve its air force, Taiwan plans to develop cluster bombs. It plans to develop a stealth paint for the IDF, improve its fuel capacity, and give it in-flight refueling.[29] It is also seeking a next-generation stealth fighter, presumably the Joint Strike Fighter.[30]

Taiwan's air defenses include numbers of U.S.-made Patriots (PAC-2 plus), Hawk, Chaparral, Stinger, and Avenger surface-to-air missiles, and the domestically produced Tien Kung or Sky Bow surface-to-air missile operated by the Army. The Patriot can intercept short-range ballistic missiles, but Taiwan does not have enough Patriots to defend the entire island, having only 200 concentrated around Taipei.[31]

Taiwan's Sky Bow II may have only a limited ballistic missile defense capability.[32] A program intended to upgrade its Sky Bow II was left incomplete due to a shortfall in funding.[33] Accordingly, Taiwan has asked the United States to sell them better defenses against ballistic missiles, including long-range radar like Aegis and next-generation Patriots, and has upgraded its ballistic missile defense installations to accommodate PAC-3.[34]

Long-range radar would improve Taiwan's missile launch warning

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times and allow for better fire control of its Patriots. Currently, Taiwan has only a mere 90 seconds from detecting a ballistic missile attack to launch its Patriots.[35] As reported in April 2000 by the *New York Times* in an interview with General Wang Chao-tai of Taiwan's Air Defense Missile Command:

> That 90-second warning time – Patriot radar systems pick up incoming missiles on their final downward trajectory – also weighs on General Wang's mind.
>
> "We have the capacity to intercept their missiles," the general repeated. "But if we had longer-range radar, we could make better decisions." In the best of circumstances, Taiwan would have only six to eight minutes, the estimated flight time from their inland launching sites.[36]

In April of 2001 and 2000 Taiwan asked the U.S. to authorize them to purchase Aegis destroyers, which, in addition to long-range radar, feature a sophisticated battle management system that can keep track of multiple targets. It also requested permission to purchase more Patriots and for four Kidd-class destroyers (nicknamed the "Ayatollah" class being originally built for Iran), P-3 submarine patrol aircraft, diesel submarines, long-range radar, high-speed anti-radiation (HARM) missiles, improved munitions, missiles, and battle management capabilities, and the release of its AIM-120C missiles from the United States to Taiwan.[37]

In 2001 a confidential review by U.S. naval officers concluded that Taiwan needed a significant infusion of new weapons, including Aegis destroyers. It concluded Taiwan needed new submarines, and an underwater sonar array. It recognized the value of the Kidd-class destroyers.[38] While not equipped with Aegis, the Kidd-class would be the largest destroyers in Taiwan's navy, and a step toward Aegis.[39]

Taiwan's request for submarines was criticized, striking "some Asia specialists in Washington as odd."[40] Yet submarines could be invaluable in relieving a blockade. They could attack Chinese warships, engage in anti-submarine warfare, and provide a deterrent.[41] They could deploy Taiwan's new, third-generation, anti-submarine mobile mine, the WSM-III, a rocket-assisted, straight-rising mobile mine.[42]

The sale of submarines to Taiwan would require the United States to re-develop its ability to produce diesel submarines: it has built only nuclear-powered submarines since the 1960's. It could build diesel

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submarines, presumably with AIP (Air Independent Propulsion), using designs from other countries.[43] While Sweden, Netherlands, and Germany have said they will not supply Taiwan because of agreements with the PRC, other countries may.[44] In addition, Taiwan's major shipbuilder CSBC has said it is willing to build submarines if given help with their design.[45]

Some have suggested that diesel submarines could prove a helpful addition to the U.S. Navy even though they lack the range and speed of nuclear submarines. Small, stealthy, diesel submarines could be useful in the shallow waters of the South China Sea. At a minimum, they could be used in anti-submarine warfare training.[46] Pentagon Director of Defense Research and Engineering Hans Mark has advocated their acquisition.[47]

In 2001 the Bush administration denied Taiwan's request for Aegis destroyers, but apparently left the door open for a later decision on an "as-needed basis."[48] It softened its denial with the sale of eight diesel submarines and the four Kidd-class destroyers. It also agreed to sell 12 P-3C submarine patrol aircraft, Mk-48 torpedoes (but not the most advanced version) MH-53E minesweeping helicopters, and other items. It agreed to brief Taiwan on PAC-3.[49] Even without Aegis, the arms sale was welcomed by Taiwan.[50]

Strategy

Since Taiwan Strait is only 90-100 miles wide at points, it is easy for the PRC to threaten Taiwan with ballistic missiles, air and naval attack, and amphibious invasion, and even simply information warfare.

Taiwan's defense strategy has been based on maintaining a strong army and using air and naval power to repel an invasion. To offset Taiwan's vulnerability, President Chen Shui-bian has advocated a new strategy of "offshore engagement."[51] Under offshore engagement Taiwan would attack Chinese invasion forces before they reached Taiwan and offer retaliation with a "mobile strike" capability.[52]

To improve its offshore engagement capability, Taiwan plans to use air and naval forces to attack nearby Chinese bases. For example, Taiwan plans to use its new RGM-84L Harpoon anti-ship missiles in counterattacks against important land targets as well as warships.[53]

With its longer range and greater maneuverability, the Harpoon is expected to replace Taiwan's Hsiung Feng-II cruise missile on its Cheng Kung-class frigates. The Hsiung Feng-II will be re-deployed to the Ching Chiang-class patrol boats.[54] Taiwan's development of a cruise

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missile is noteworthy.

Taiwan has developed a new ship-to-ship cruise missile, the Hsiung Feng-III, to balance the PRC's Russian-made "Sunburn" cruise missile. Vertically launched, the Hsiung Feng-III has an estimated range of 600 km (360 miles) compared to 240 km for the Sunburn. Powered by a ramjet, its speed is over Mach 2 like the Sunburn. The Hsiung Feng-III is expected to be test-fired in April 2001 and enter production at the end of 2001.[55]

Taiwan is also developing a short-range ballistic missile called the Tien Chi to attack the PRC's military bases. Developed from the one-stage Tien Kung-II, the Tien Chi is a two-stage rocket.[56] As reported by the *Taipei Times* in March 2001:

> What we know is that Chung Shan has overcome the problem [stage separation]. Now they have only one major problem to tackle – what kind of warhead they want to use on the missile. . . Since the Tien Chi is a variant of the Tien Kung-II, it has much the same payload as the latter. The Tein Kung-II has a small payload of only 100kg.[57]

Taiwan's ballistic missile project is still under development. But it shows a trend where Taiwan is willing to engage the PRC offshore. Paradoxically, as the PRC threatens Taiwan with ballistic missiles, unconfirmed reports indicate how in the 1980's the United States pressured Taiwan from developing its Tien Ma (Sky Horse) ballistic missile with a 1,000 km (620 mile) range.[58] The importance of Taiwan's strategy of offshore engagement was reported by CNN November 2000 in an interview with Andrew Yang of the Taipei Institute of Strategic Studies:

> The key to defending Taiwan's interests, said Yang, is to "develop an offensive capability" that will enable the island to return "retaliation toward the other side."[59]

Naval Forces and Army

Taiwan's lifeline depends on its sea-going trade. Taiwan has taken care to build up its naval strength in frigates and destroyers to defend it from invasion and blockade, and to conduct anti-submarine warfare. Frigates equipped with ship-to-ship missiles can also provide a means of retaliation.

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Taiwan's Kidd-class destroyers, expected to be delivered in 2003, will upgrade its naval capabilities. While nearly 20 years old and utilizing older technology, the Kidds have another 20 to 30 expected years of service left in them and will provide a pragmatic step toward Aegis at only about one-sixth the cost.[60]

The Kidd-class destroyers are 172 meters long, weigh 8,910 tons, and are capable of 33 knots. They are powered by four gas turbines, the same turbines used in Taiwan's Cheng Kung-class frigates, simplifying maintenance and logistics. Their radar has an effective range of 350 kilometers. They can fire four surface-to-air missiles simultaneously within a range of 70 kilometers.[61]

The Kidds are equipped with SQS-53A sonar and carry sub-hunting helicopters.[62] They have eight tubes for launching Harpoon anti-ship missiles, two five-inch guns, six torpedo tubes, and two Phalanx close-in-weapons-systems for short-range defense.[63]

Purchase of the Kidds has been criticized, however, because of concern over their large size making them a target for anti-ship missiles, and a belief that small missile boats under 200 tons can better meet Taiwan's defense needs.[64] Missile patrol boats, relying on small size for stealth do not, however, carry equipment or weapons for anti-submarine warfare or air defense, which are needed for Taiwan's defense.

Taiwan must be concerned with defeating submarines, naval blockades, and air attacks, which requires larger vessels like the Kidds. But this criticism over the Kidds brings up an important point - the need for U.S. and Taiwanese naval forces to improve their cruise missile defense, mine and torpedo (anti-submarine warfare) defenses.

Along with its future acquisition of Kidds, Taiwan has six modern Lafayette-class frigates it bought from France and six Knox-class frigates it bought from the United States. It has seven domestically-built Cheng Kung-class frigates patterned after the U.S. Oliver Hazard Perry class, and is building an eighth Cheng Kung with an estimated delivery time of 36 months.[65]

The Cheng Kung-class, at 4,200 tons, has anti-air, anti-surface, and anti-submarine capabilities. It is equipped with two anti-submarine helicopters. It carries eight Hsiung Feng-II surface-to-surface missiles, and 40 Standard air defense missiles. It has a 76-mm (about 3 inches) rapid-fire gun; two 40-mm anti-aircraft guns; a Phalanx close-in gun for cruise missile defense; and torpedoes. The Cheng Kungs are based at the Tsoying naval base in Kaohsiung, one of Taiwan's two major

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ports.[66]

Taiwan also has four World War II vintage U.S. Gearing-class destroyers it plans to replace with the Kidds. It has other vessels such as the Ching Chiang-class missile patrol boats, and assorted patrol boats and minesweepers.[67]

Taiwan has two modern submarines it purchased from the Netherlands in the 1980s: the Dutch Zwaardvis or "Sea Tiger" class, which are small, stealth, and highly automated. Its two World War II-vintage U.S. Guppy-class submarines are used for training.[68] The arms sale agreement by the U.S. to provide Taiwan with eight new diesel submarines will mark a substantial improvement in its naval capabilities.

Taiwan also has numerous, small amphibious vessels. In July 2000 it commissioned a 8,600-ton amphibious transport, a landing ship dock, the largest ship in its navy.[69] It would use its amphibious vessels to reinforce its islands of Kinmen and Matsu offshore from the Chinese mainland, and the Pescadore Islands which lie in the Taiwan Strait and include Penghu Island with its air base.

Taiwan's army is equipped with relatively modern equipment such as AH-1W attack helicopters, OH-58D scout helicopters, M-48H and M-60A-3 tanks, anti-tank weapons, and howitzers. It is buying 100 domestically-produced multiple launch rocket system (MLRS) for stopping amphibious landings, the "Thunder 2000" developed by the Chungshan Institute, which is expected to enter mass production in the next two years. The Thunder 2000 will replace the aging Kung-Six multiple barrel rocket system.[70]

The army is updating its short-range air defense missiles with the U.S. Avenger that uses a HMMWV (high-mobility multi-purpose wheeled vehicle) with a turret launcher in the rear armed with eight Stinger missiles. Avenger is a short-range air defense system with a maximum effective range of 4.5 km. Hawk and Patriot are longer range.[71]

Ballistic Missiles

Taiwan relies heavily on its air and naval forces. The PRC believes it can overcome Taiwan's strength by a preemptive strike against its air and naval bases using ballistic missiles and information warfare, possibly cruise missiles. A ballistic missile strike would be followed by air attacks.[72] Since the PRC has developed ballistic missiles with improved accuracy, a salvo of ballistic missiles aimed at Taiwanese military bases

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and radar stations would be likely to knock them out or disrupt their operation.

While Taiwan's 200 Patriots will provide some measure of defense against a ballistic missile attack, the PRC has deployed more than 300 short-range ballistic missiles against Taiwan and has stepped-up their production.[73] And it plans to deploy 600 or more short-range missiles against Taiwan.[74]

The PRC's short-range ballistic missile bases are inland and are protected by air defenses. They have underground bunkers for storing and protecting the missiles. As a result, it will be difficult for Taiwan to mount a preemptive strike or counterattack against the PRC's ballistic missile bases, putting Taiwan on the defensive.

Since Taiwan does not possess heavy bombers, counterattacks against Chinese missile bases or forces will rely on fighters equipped with a light payload of munitions or cruise missiles. These counterattacks will tend to be for counterforce missions - attacking Chinese military forces near Taiwan. Except for its future acquisition of submarines, Taiwan thus lacks a key element of deterrence - the ability to threaten punishing retaliation.

In January 2001 a U.S. miliary mission warned that Taiwan was vulnerable to a conventional air attack, and attacks using ballistic missiles and information warfare. As reported by *Agence France Presse* in January 2001:

> Taiwan is ill-prepared for a military first strike by rival China despite continuous efforts by the island to build up its defenses, it was reported Sunday. "Taiwan's air and naval bases, radar stations, and other major military facilities were weak in the capability of resisting bombing . . ."

Sketching an invasion scenario in a recent report, Taiwan's defense ministry said the PRC could launch missiles to paralyze the island's political and economic establishment, followed by a blockade and air and amphibious attacks. . . .The report also warned of the PRC's increasing military capacity in other areas, such as cyberspace, command and control center strikes, psychological attacks, and covert operations.[75]

In January 2000, the Pentagon produced a 40-page classified report warning "Taiwan is far more vulnerable to attack from China than is generally recognized because its isolated military has fallen behind

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technologically." It highlighted Taiwan's vulnerability to ballistic and cruise missiles.[76] Others have noted Taiwan's vulnerability, such as the Henry L. Stimson Center.[77] As noted in the Washington Post in April 2000:

> The PLA has studied the American way of war closely – Chinese military and strategic journals are loaded with such analyses – and has learned a number of lessons. Many in the PLA believe that if China decided to attack, it could employ massive missile strikes to cripple Taiwan's capital, Taipei, in the same way that American forces used cruise missiles and "stealth" aircraft to render Belgrade defenseless. . . .

As devastating as such strikes would be, their real importance would be to leave the country defenseless to subsequent attacks by bombers and fighter planes. Missile strikes would have a good chance of catching Taiwan's air force in its hangers and rendering Taiwan's military airfields useless for a significant period, offsetting the primary advantage Taiwan now holds over the PLA as well as complicating America's resupply and reinforcement efforts. Since Taiwan's most modern aircraft are based at just three airfields, fewer than 50 missiles could cripple Taiwanese air operations.

Other strikes would target Taiwan's command and control networks and air defense radars. These fixed sites, most of which are well-known to Chinese military intelligence, are extremely vulnerable. Such a preemptive attack also would leave the United States with few attractive military options to defend Taiwan.[78]

This finding about Taiwan's vulnerability is hinted at in a December 2000 Pentagon report noting the importance of ballistic missiles and information warfare to the PRC's war plans and key gaps in its ability to assess conflict between the PRC and Taiwan.[79] The importance of ballistic missiles to the PRC's war plans is illustrated in how it launched six M-9 ballistic missiles off Taiwan in 1995, and launched four M-9 missiles off Taiwan in 1996 in an attempt to influence Taiwan's presidential election.

Painfully aware of its vulnerability to ballistic missiles, Taiwan has asked to purchase better missile defenses such as Aegis destroyers with their advanced radar. Taiwan knows it needs improved, long-range radar, and longer range interceptors. The Taiwanese military has asked for more funding for ballistic missile defense, but its government has

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been hampered by budget shortfalls caused in part by Taiwan's economic downturn.[80]

Information Warfare

Aware of its vulnerability to information warfare, Taiwan has been improving its information warfare capabilities. These improvements include development of improved computer security systems in a project codenamed "Chihan," and development of a protective shield to defend computer systems against possible electromagnetic pulse (emp) bomb attacks in a project codenamed "Maihu."[81]

Chihan, Maihu, and similar projects are to begin in 2001 and last for four years. They are among 11 new projects for strengthening Taiwan's defenses. Taiwan also plans to modernize its radar system. This project, codenamed "Anyu," will replace Taiwan's older two-dimensional radar systems with three-dimensional radar systems and automated control. It is expected to be completed in 2004.[82]

In addition, in 1998, Taiwan started planning for its first information warfare unit to counter the PRC's growing strength in information warfare.[83] This unit, comprising nearly a battalion of specialized troops, is independent of any service and under the direct control of the office of the chief of the general staff.[84] It was put into operation in January 2001, and is expected to be enlarged and strengthened in the future.[85]

The growing importance of information warfare to Taiwan is noted by Lieutenant General Abe Lin, director of the Communication Electronics and Information Bureau (CEIB) under the Ministry of National Defense in an interview with the *Taipei Times* in November 2000:

> Our defense spending for the next year is to prioritize the development of IW and electronic warfare capabilities. Investments in the two areas, as well as relevant C4ISR [command, control, communication, computer, intelligence, surveillance, and reconnaissance] fields are to account for 23 percent, or [about] one fourth, of the total budget.[86]

With its focus information warfare, Taiwan introduced a simulated computer maneuver with its annual military exercise, Hankuang No. 17, held in March 2001.[87] But in spite of Taiwan's progress in information warfare, the Taiwan Research Institute has called for more support for

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information warfare, noting the PRC's mounting military threat and Taiwan's need for an effective battle management system.[88]

Defense Spending

Taiwan's military possesses certain strengths. It has, in addition, developed new weapons such as cruise missiles, jet fighters, and beyond-visual-range air-to-air missiles. But Taiwan also has areas of weakness going beyond its vulnerability to ballistic missiles and information warfare which may be attributable to declining defense budgets.

But while Taiwan has decreased its defense budget, it has attempted to do so under a modernization program focused on reducing its numbers of personnel while acquiring new weapons, using the same strategy which the PLA has adopted for its own modernization program.

Taiwan plans to modernize its forces over the next five years and continue streamlining personnel under the Chingshih program. Under the Chingching project, Taiwan trims the military from 386,000 to 350,000 personnel while enhancing its electronic warfare and early warning capabilities, information warfare, and purchasing new arms. Four years ago, Taiwan's military numbered 450,000.[89] In comparison, the PLA has streamlined its forces by cutting roughly 500,000 personnel.

Nonetheless, cutbacks to military personnel begun under the Chingshih streamlining project have created a logjam in promotion for lower grade officers, affecting morale.[90] A few disaffected mid-ranking officers are taking early retirement and going to the PRC, such as retired ex-department chief Pan Hsi-hsien, where they pose a security risk.[91] In 2001 Taiwan's Ministry of National Defense was censured for reserve training behind required levels.[92]

In the Air Force, Taiwan faces a shortage of pilots especially for its F-16s; but the air force is taking steps to correct this shortage, having announced a series of reforms.[93] In the Navy, Taiwan's Lafayette class frigates need maintenance, and their machine guns are rusting.[94] Its 26 S-2T anti-submarine aircraft are falling apart with only six out of 26 operational.[95] Its request to purchase new P-3 anti-submarine patrol aircraft is based in part on the aging condition of its S-2Ts.

While Taiwan has a credible number of frigates for anti-submarine warfare, the decaying condition of its anti-submarine patrol aircraft

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would hamper it against the PRC's more than 60 submarines. If the PRC were to achieve dominance in the air or launch a preemptive strike against Taiwan's naval forces, Taiwan would be pressed. The island is susceptible to blockade.

In July 2000 Taiwan's defense budget shortfalls caused the Chief of the General Staff, General Tang Yao-ming to attack former Premier Tang Fei, himself a retired general, for failing to increase defense spending citing a breach in promises made months earlier when Tang Fei served as defense minister and promised to raise defense spending from its current 2.7 to 3.5 percent of GDP.[96] Yet, President Chen Shui-bian has sought to support the military, participating, for example, in its Hankuang No. 16 military exercise for meeting a Chinese attack.[97]

Taiwan's defense budget for fiscal 2001 was cut to NT$271.9 billion (US $8.5 billion) from an original projection of NT$320 billion.[98] Defense spending now accounts for only 16.91 percent of the government's total budget, the lowest percent in decades. In comparison, in fiscal 1991, defense spending represented 30.34 percent of the government's total budget, reflecting a shift toward non-defense spending priorities.[99]

Taiwan's cut in defense spending reflects its budget shortfalls and economic downturn. It also reflects fighting between the DPP and KMT in the legislative Yuan where, for example, KMT legislators threatened to delete more than NT$200 million from the first stage of acquisition of the Pave Paws radar, and the National Huwei Institute of Technology had its budget cut by NT$1 million merely because it invited Vice President Annette Lu to speak.[100]

While this reduction in its defense budget may be seen as a test of Taiwan's commitment to its own defense, the United States has very little to say when it, for example, has neglected its defense against ballistic missiles. Taiwan's defense against ballistic missiles is imperfect, but the United States has no defense against ballistic missiles.

Taiwan is a democracy like the United States, the Western European nations, and other countries where defense spending competes with social programs. Increases in defense spending are almost always unpopular unless threats are clearly established and the political will is exercised to meet those threats.

In addition, Taiwan has been influenced by a belief that its investment and trade with the PRC make it unreasonable for the PRC to attack it.[101] It believes its role as an international supplier of computers provides it with a "silicon shield."[102] Similar beliefs are held

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by the United States, which believes that trade with the PRC and its engagement in international organizations will bring about peaceful relations.

The desultory support the United States gave Taiwan in its purchase of new weapons until April 2001, and U.S. arms-control and non-proliferation have de-emphasized the importance of a strong defense for Taiwan.[103] Responsibility must be accepted for how the United States stopped Taiwan from its nascent nuclear weapons program in the 1980's, pressured it to mothball its Sky Horse ballistic missile program, and severely limited contact between its military and the Pentagon.[104]

The U.S. emphasis on negotiations has not contributed to Taiwan's defense.[105] However, the United States has sold Taiwan modern weapons when other countries would not because of opposition from the PRC.

Investment in Technology

Taiwan's investment in research and development is declining, affecting its economy. This has happened in part because of its investment in the PRC.[106] For example, Taiwan's research and development budget grew an average of 10.7 percent annually between 1994 and 1999, but dropped to 8 percent in 2000 due to its economic slowdown.[107]

Taiwan's private investment in research and development grew an average of 16 percent annually between 1997 and 1998, but dropped to 8.9 percent in 1999. As a percent of GDP, its spending for research and development was 2.05 percent compared to 2.84 percent for the United States, 2.98 percent for Japan, and 2.89 percent for South Korea.[108]

The PRC has benefited from Taiwanese investment in advanced technology and industry. This investment, focused on computer chip manufacturing and petrochemicals, is estimated at $40 billion or more.[109] Taiwan's investment in the PRC was noted by Taiwan's Vice President Annette Lu, as reported by the *Taipei Times* in January 2001:

> Lu said that 40 percent of Taiwan's total foreign investment is in the PRC, and two-thirds of that amount is invested in electronics and high technology. Despite political rivalry, Taiwan businesses have poured more than US$40 billion into the PRC, attracted by a giant market, cheap land and labor, and a common language and

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culture.[110]

But investment in advanced technology supports the technological and industrial base for developing advanced military weapons. Modern warfare depends heavily on advanced technology and its infrastructure of industry, science, education, and research and development. Taiwan, like the United States, is inadvertently assisting the PRC develop its technological base for modern warfare.

Public policy both in Taiwan and the United States needs to recognize how investment in a foreign country, although it may be attractive in the short-term in a business sense, may not be in a country's best interest. Public policy must recognize national need for capital investments to improve productivity, and maintain a strong technological and industrial base for defense.

Taiwan and the United States need to recognize that investment in the PRC does not necessarily lead to peace. If investment and trade with the PRC could buy peace and freedom, Taiwan has shown that it does not.

The PRC's Preparations

The PRC's preparations are such as would facilitate a surprise attack on Taiwan using information warfare and ballistic missiles, "winning victory with one strike" using a strategy of "asymmetrical" assault.[111] It plans to leverage its military power by taking advantage of the benefits of a surprise attack that seizes the initiative and puts the other side on the defensive. The PRC plans to disrupt Taiwan's C^4I, and attack Taiwan's radar, air defenses, air and naval bases, and other military bases using information warfare, and ballistic and cruise missiles.[112] The PRC's 300-400 M-11 and M-9 short-range ballistic missiles deployed near Taiwan give it the ability to strike a swift, powerful blow.

The PRC's M-11 and M-9 missiles have ranges of about 200 to 400 miles.[113] The M-11 missile, also known as the DF-11 or CSS-7, has a shorter range than the M-9, which is also known as the DF-15 or CSS-6. The PRC is deploying hundreds of its new CSS-7 Mod 2 missiles, a longer range version of the CSS-7 with a range of 300 miles.[114]

The CSS-7 Mod 2s are expected to carry several types of warheads, including high-explosives, cluster bombs, and fuel-air explosives. It may carry small nuclear warheads such as the small Chinese nuclear

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warhead the CIA believes was built using U.S. technology for the W-88 warhead.[115]

The PRC is deploying its CSS-7 at new missile bases at Xianyou, 135 miles from Taiwan, and Yongan, 220 miles from Taiwan, in the coastal province of Fujian. Each base is estimated to house a brigade of 16 truck launchers and 97 CSS-7 missiles, and has tunnels - underground bunkers - for storing the missiles.[116]

A third, older, missile base is located at Leping, 362 miles from Taipei in the province of Jiangxi. It has a brigade of about 100 of the older, longer-range CSS-6 missiles, and is "brigade headquarters" for all PLA ballistic missile units near Taiwan.[117]

The deployment of short-range ballistic missiles in Fujian province has also been reported at Xienyu, Pingtan, and Lienchen.[118] In addition it has been reported that the PRC has established a CSS-6 missile "training base" at Fuzhou, directly across the Taiwan Strait from Taipei.[119]

The PRC is increasing its production of CSS-7s from a factory at Yuanan, about 175 miles west of the provincial capital of Wuhan in Hubei province. The Yuanan factory, part of the Sanjiang missile group, is being expanded.[120] Intelligence estimates of the PRC adding 50 short-range missiles a year against Taiwan may need to be revised.[121]

In addition to its ballistic missiles, the PRC is increasing its air power, buying 48 Su-27 fighters from Russia, and licensing production of 200 more Su-27s, designated the F-11 (Jian-11).[122] The PRC is currently producing around 10 to 20 Su-27s annually.[123]

In addition, in June 1999 the PRC signed a contract to buy 72 Su-30MK fighters and license production of 250 Su-30MKs. It is receiving Su-30s from Russia.[124] The Su-27 and Su-30 jet fighters are roughly comparable to the U.S. F-16 and F-15. In addition, some analysts report that the PRC has received hundreds, not "several dozen" Russian jet fighters and bombers.[125]

The PRC is basing many of its new fighters near Taiwan. It is deploying 10 new squadrons (a squadron in the Chinese Air Force comprises roughly four to eight aircraft) in the Nanjing military region 500 km (300 miles) from Taiwan. These squadrons are made up of four squadrons of Su-27s, four squadrons of the Chinese-built J-8 fighter, and two squadrons of the Chinese-built Hung-7 bomber. The fighters deployed near Taiwan used to be the outdated Jian-6.[126]

These new squadrons mark a significant build up in the PRC's air force.[127] With its buildup of air power, the PRC has become

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increasingly aggressive in challenging Taiwan's airspace using its Su-27s, similar to the EP-3 incident.[128]

In addition to its acquisition of new fighters, The PRC is developing the ability to project air power at long ranges. It has developed, for example, the Shaanxi Y-8 long-range maritime patrol craft equipped with the British Skymaster maritime search radar for prolonged surveillance in the South China Sea, which will be able to detect small boats and even submarine periscopes at more than a hundred nautical miles.[129]

The PRC is also purchasing the Russian A-50 AWACS, and is planning another attempt to buy the Israeli Phalcon Early Warning Airborne Radar, which the U.S. successfully opposed in 2000.[130] The acquisition by the PRC of AWACS will substantially improve its projection of air power.

In addition, with Russian assistance, the PRC is modifying its Hung-6 bombers and Russian made Il-76 transports to provide aerial refueling, enabling it to project air power across the South China Sea.[131] Aerial refueling will extend the range of the PRC's fighters, enabling them to challenge U.S. air superiority.

In addition to its growing air power, the PRC is strengthening its air defenses near Taiwan, building a new air defense base in the city of Zhangzhou about 175 miles due west of Taiwan, and equipping it with road-mobile Russian S-300s surface-to-air missiles (SAMs). In its 1996 military maneuvers the PRC temporarily deployed S-300s at Fuzhou, further to the north.[132]

The Russian S-300 is an advanced, mobile air defense missile for intercepting aircraft and cruise missiles. It is a family of air defense missiles that includes the SA-10, SA-12, SA-15, and SA-20. It has a range of up to 200 kilometers. Some models can intercept short-range ballistic missiles that have a slower reentry vehicle.[133]

U.S. electronic warfare specialists say some radars used by the S-300 family are impossible to jam with current U.S. equipment. Russian radars can spread pulse signals over a broad bandwidth, vary waveform, and change polarization; a battery of radar transmitters can network target data and take turns transmitting to avoid being hit by anti-radiation missiles.[134]

Deployed at Zhangzhou, the S-300 can provide air defense out to Taiwan's Penghu Islands (the Pescadores). Deployed at Fuzhou, it could intercept aircraft as far as Hsinchu on Taiwan's west coast.[135]

The PRC surface-to-air missile base at Zhangzhou is part of an

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effort to defend a major air base at Zhangzhou where over the past two years it has deployed 24 H-5 fighter-bombers, six F-7 fighters, F-8 reconnaissance aircraft, and other aircraft, which fly the Taiwan Strait.[136]

Along with its inventory of about 120 S-300 surface-to-air missiles, the PRC is developing the FT-2000 surface-to-air missile system as an enhanced version of the Russian S-300. It will have greater targeting capabilities, including ground targets, and longer range.[137] The PRC has also developed the CSA-1 surface-to-air missile.[138]

In November of 2000, the PRC revealed a new, supersonic, anti-ship and anti-radar cruise missile capable of being launched across the Taiwan Strait. It would be carried by the PRC's JH-7 fighter-bomber.[139] Anticipating retaliatory air strikes by Taiwan, the PRC is also deploying surface-to-air missiles to protect Hong Kong and the neighboring city of Shenzhen, the PRC's prosperous economic zone set up to attract foreign investment and technology. The PLA has set up four surface-to-air missile camps: one in Daya Bay where a nuclear power plant is located, another in Shenzhen, and two on nearby, outlying islands. At least nine advanced air defense warning systems have been set up in Shenzhen's downtown area.[140]

To protect its short-range ballistic missile and other military bases in Fujian, the PRC is deploying the Russian Tor M1 surface-to-air missile. It has deployed at least 100 companies of Tor-M1s. Each company is comprised of 4 launchers capable of simultaneously launching 8 missiles that have a range of up to 40 km (24 miles) and altitude up to 12 km (7 miles).[141]

The PRC has also deployed hundreds of Qianwei missile-artillery air defense systems, which are copied from the Russian Tunguska. And it has deployed thousands of its own surface-to-air missiles and artillery units.[142]

The PRC is also developing an early warning radar to detect stealth aircraft by monitoring disruptions in commercial radio and TV signals – a Passive Coherent Location detection system.[143]

To strengthen its navy the PRC has purchased two Russian Sovremenny destroyers equipped with SS-N-22 "Sunburn" supersonic cruise missile, and plans to buy two more Sovremennys.[144] In addition to the Russian "Sunburn," the PRC has its own anti-ship cruise missiles, the advanced C-801, for example, which it has sold to Iran. The PRC is also developing a supersonic derivative of the Sunburn, which it may have tested in January 2001.[145] The PRC may have tested the Russian

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Sunburn in February 2001.[146]

To improve its submarine forces, the PRC has bought four Russian Kilo class submarines, 50 wake homing torpedoes, and the Russian Shkval rocket torpedo that travels at 200 knots.[147] It is building the first of a new class of nuclear power attack submarines, Project 093, with the aid of Russian technicians at Huludao, to replace the unreliable Han class.[148] Its Project 094 ballistic missile submarine, which will carry the JL-2 SLBM (Submarine Launched Ballistic Missile), is still in design.

The PRC's acquisition of Kilo submarines is significant. Its Kilos pose a threat to the United States as well as Taiwan. Kilos are among the quietest conventional submarines in the world. Coupled with the PRC's Song class, they provide a generational leap in the PRC's submarine technology.[149] Compared to Sovremenny destroyers, "the four quiet Kilo SS submarines might represent a greater threat to naval forces in Asia."[150]

The PRC is also building an aircraft carrier, has a large stock of intelligent mines, and is developing its amphibious capability.[151] Four new 5,000 ton Yuting landing ships have been completed in the past year (2000), bringing the total number of these ships to 10. In 2000 the PRC's capacity to transport at sea was assessed at 11,000 troops and 250 main battle tanks.[152] The PRC can use other transports, small craft, and destroyers to increase its amphibious capability. In the narrow Straits of Taiwan the turnaround time for amphibious ships and craft would be very short. There is little reason to doubt the PRC's ability to carry out an amphibious invasion of Taiwan, or assert its naval superiority by blocking the island's ports.[153]

The PRC's preparations against Taiwan include extensive training in artillery and ballistic missiles, information warfare, and plans to counter U.S. forces. It includes exercises for invasion. In addition, the PLA is training its officers to win in any high-tech conflict.[154] To assist it in high-tech warfare, the PLA has implemented a new battle management system called Qu Dian, for coordinating and supporting its aircraft, ships, submarines, and ground forces.[155]

Like the U.S.-led coalition victory over Saddam Hussein in Desert Storm, Qu Dian is a major force multiplier relying on satellites such as the PRC's Feng Huo-1, the first of several military communication satellites for Qu Dian launched on January 26, 2000. It is similar to the Pentagon's Joint Tactical Information Distribution System, or JTIDS, and boasts a "secure, jam-resistant, high capacity data link communication system for use in a tactical combat."[156] It adds to the

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PLA's computer-based warfighting simulation system given it by the U.S. Army in 1998.[157] Qu Dian and Feng Huo-1 illustrate the PRC's increasing reliance on space. The PRC sees its space program as providing it with the means to evade the proposed U.S. theater and national missile defenses by taking advantage of low-power space rocket technology to enable the PRC's missiles or warheads to conduct evasive maneuvers, changing trajectory to evade an interceptor.[158]

In addition, the PRC is developing long-range cruise missiles, the HungNiao, or HN-1 and HN-2, which will have ranges of 1,300 km and 3,000 km respectively. These cruise missiles, like the PRC's intermediate and long-range ballistic missiles, will substantially increase its ability to project power across Asia and the Pacific.[159]

The PLA's training in high-tech warfare comes as it upgrades the education of its officers to increase their technological skills. The PLA now boasts 26,000 college graduates with doctorates and masters degrees. In the Second Artillery Force, in charge of strategic and conventional missiles and related high-technology combat, more than 90 percent of its combat units have qualified engineers in command.[160]

The PLA wants even more officers with college degrees. It sees leadership in technology as critical to its success in high-tech warfare against Taiwan, Japan, and the United States.[161] It has established five universities - the universities of national defense science and technology, information engineering, science and engineering, naval engineering, and air force engineering - to assist in the training of its officers.[162]

The PRC's growing leadership in high-tech warfare comes in part from its growth in commercial electronics. The PRC is expected to become one of the world's top producers of information technology hardware in the next five years, fueled in part by international investments from Taiwan, United States, and other countries. In domestic consumption, the PRC's internet access soared 91 percent in 2000, and personal computer sales were expected to increase 20 to 30 percent. Every year, the PRC reportedly produces 400,000 engineers, equivalent to half the total engineering population in Silicon Valley, and nearly five times the number at Hsinchu Science Park in Taiwan.[163]

The PRC's burgeoning commercial information technology industry and improvements to the technical education of the People's Liberation Army represent a vast pool of technological talent it will be able to draw on in future conflicts with the United States. The U.S. needs to recognize the challenge it faces in technical education – math, science,

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and engineering. As with Sputnik in 1957, the PRC's technological advances challenge U.S. education.

Military Exercises

The PRC's preparations for war against Taiwan and to ward off any effort by the United States to aid Taiwan include extensive military exercises. In May 2001 the PRC conducted large-scale joint warfighting exercises in the South China Sea from Hainan Island to the Spratly Islands, and in May-June 2001 amphibious exercises centered around Dongshan Island.

The scale and sophistication of these exercises deserve comment, more than the remark of their being "not unusual" according to the U.S. State Department.[164] The large-scale beach landing exercises centered on Dongshan Island, for example, reportedly involved 100,000 troops and over 200 amphibious vessels, along with naval and air forces, and was the largest such exercise since 1996.[165] The scale, at corps or army level, is the same scale that would be used to attack Taiwan or overrun its outlying islands.

These exercises also deserve comment for their planning to attack and occupy Taiwan's offshore islands, and counterattack U.S. military intervention.[166] This type of attack would mark an encirclement of Taiwan. The exercises, lasting for two weeks, involved advanced fighter planes, warships, missiles, and electronic-warfare equipment, and would provide realism and depth to the PRC's introduction of new tactics.[167] They included simulated attacks on U.S. aircraft carriers.[168]

The timing of these exercises occurred just as in late May of 2001 the PRC's northern fleet practiced a "rapid dispersal exercise" that would be done in the event of an approaching storm or imminent hostile action.[169]

The amphibious exercises follow the PRC's large-scale military exercises in the South China Sea that were noted as "unusual," and a step in the buildup of its forces for conducting operations further from the Chinese mainland. The exercises included the use of Woody Island in the Paracel Islands, with its long runway and fuel depot.[170]

The PRC's military exercises are pointed at the United States, Taiwan, and Japan, and are intended as a reminder of its growing capabilities.[120] In October 2000, the PRC's ground forces, missile corps and naval units mobilized 10,000 soldiers in its largest public display of weapons and skills since 1964. As reported by the Associated Press:

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> Helicopters, small naval vessels, armored vehicles, missile batteries and an array of other weapon systems took part in the demonstrations held at three locations in northern China and in the Bohai Gulf ... "High-tech training is crucial to fighting and winning a war under the conditions of modern high-technology," CCTV quoted Jiang telling troops and more than 100 generals standing at attention before him.[172]

Significantly, the PRC's October 2000 war exercises included new capabilities to attack stealth aircraft and cruise missiles, making it clear how the PRC views the United States and is preparing to counter its most sophisticated weapons.[173] This view is corroborated, for example, how in 1998 when the PRC issued a white paper on national defense it mentioned the United States 10 times each positively, but in 2000 when it issued its new white paper on defense, in thirteen references to the United States, all but two were negative.[174]

In addition, the PRC's flight tests of its new DF-31 ICBM in November and December of 2000 were meant to warn the United States against selling arms to Taiwan in spite of downplaying by the Pentagon.[175]

Other Chinese military exercises have been aimed at U.S. forces. For example, in September 2000 the Pentagon monitored a Chinese exercise involving a mock seaborne blockade of Taiwan with two U.S. aircraft carrier groups. Surprisingly, the PLA had the U.S. carriers just sit there, instead of intervene, possibly because the PLA believes the United States will not risk the loss of life to help defend Taiwan.[176]

The PLA believes the United States can be easily intimidated, especially if casualties would result. For example, when U.S. Admiral Dennis Blair met privately in Beijing with top PLA generals just before the Chinese military exercises in September 2000, and told them the United States is prepared to defend Taiwan if the PRC attacks, the PLA generals dismissed his statement as "laughable bluster."[177] As noted by Richard Halloran, in September 2000 one Chinese academic flatly declared that, "The U.S. will not fight for Taiwan."[178]

The PRC's wargames against Taiwan have also focused on using electronic equipment to destroy computer and communication systems. The PRC has practiced information warfare against Taiwan since 1985. In August 1999 Chinese computer hackers, angered by former President Lee Teng-hui's statement that Taiwan's relations with Beijing were on a "special state-to-state" basis, launched a cyberwar to destroy the

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websites of several Taiwanese government agencies.[179]

The PRC's growing information warfare capability has led Taiwan's Ministry of National Defense to rate it as a direct threat to Taiwan.[180] Even the U.S. Space Commander, Air Force General Ralph E. Eberhart, who is in charge of U.S. information warfare, has said he is worried about the PRC's growing ability to conduct computer warfare attacks against U.S. military networks.[181]

The PLA has made rapid advances in its communications and command and control. For example, it has rapidly advanced a national "plug and play" fiber-optic network to secure its military communications.[182] It tested it in December 2000.[137] The PRC's development of high-tech warfare is shifting the balance of power across the Taiwan Strait. As reported by the *International Herald Tribune* in February 2000:

> In its current configuration, Taiwan's military will have trouble confronting the newly high-tech Chinese Army . . .[184]

And the PLA has practiced information warfare. For example, in July 2000 troops from the PLA's Nanjing military region carried out a series of warfare simulations using internet "cyber drills." The drills included hacking and virus traps, and were focused on combating infiltration and sabotage: more than 2,000 computer viruses were used, having been developed for practice and attack.[185]

The PLA has practiced large-scale amphibious exercises to simulate an invasion of Taiwan repeatedly. For example, in August 2000 it held exercises off the coast of Fujian province involving PLA marines and a Sovremenny destroyer.[186] In July 2000 it held live-fire drills in a coastal area across the Taiwan Strait.[187] This followed other live-fire drills held in late May, mid-June, and late June 2000.[188]

In January 2001, in a step toward realism, the PLA staged a large-scale logistics exercise involving the resupply of ammunition, and the testing of Russian laser-guided missiles. It featured the re-supply of ammunition from inland to the coast using railways, demonstrating an improvement in PLA logistics, and a large improvement in its battle management capability.[189]

PLA battle management is expected to continue to improve as it intensifies combined services training in tandem with its military technology development and arms buildup. In addition, the PLA is expected to step up its cross-military region and combined service

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training drills, reflecting, in part, U.S. influence and training.[190]

Chinese/Russian Cooperation

A point that is often overlooked by the United States but should be of paramount importance in forging its military forces, strategy, doctrine, and diplomacy, in February of 2001 Russia conducted military exercises simulating air and missile strikes against U.S. forces defending Taiwan that were the largest it has held in a decade.[191]

The exercises included Russian nuclear cruise missile strikes on U.S. forces in the region, including troops in South Korea and Japan, from Russian Tu-22 bombers. It included test firing of three nuclear-armed ballistic missiles from land-based mobile launchers and a submarine. It included cooperation with the Vice-Chairman of the PRC's Central Military Commission, Zhang Wannian.[192]

These exercises recognize the strategic alliance between Russia and the PRC which they intend to formalize by treaty in July 2001. The treaty will provide for "joint resistance to the aggression against either of the two sides." This means, in particular, unconditional support of the PRC by Russia with all its military resources in case of Sino-U.S. military conflict.[193] It is noteworthy Russia is buttressing its long-range bombers in the Far East, which are in a position to threaten Alaska and other U.S. positions.[194]

The significance of these Russian and Chinese exercises should not be lost. They should raise the level of debate over a U.S. national missile defense and its need to re-build its military strength by an order of magnitude. While Russian conventional forces have largely deteriorated, Russia has retained much of its strength in long-range ballistic missiles and nuclear weapons. The implications of this Chinese-Russian alliance have yet to be addressed in public debate and discussion within the United States.

Obsolescence of U.S. Carrier Groups

The PRC's development of military exercises simulating the involvement of U.S. aircraft carriers needs to be noted. Since 1996 when the United States sent two aircraft carriers to waters near Taiwan, the PLA Navy has built itself up in training, doctrine, and weapons to defeat U.S. aircraft carriers.

The PLA's buildup of weapons includes its Sovremenny-class destroyers and supersonic, sea-skimming SS-N-22 "Sunburn" cruise missile designed to attack U.S. aircraft carriers. The collision of a U.S.

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EP-3 reconnaissance aircraft with a Chinese J-8 fighter evidently occurred as the EP-3 was observing a Sovremenny destroyer preparing to test-fire a Sunburn cruise missile.[195]

The PLA's buildup includes a joint effort with Russia to produce the Zvezda Kh-31P mod-2 supersonic cruise missile for attacking Aegis cruisers and destroyers that are used to screen and protect U.S. carriers.[196] It includes Kilo-class submarines, wake-homing torpedoes and Shkval rocket torpedoes. The PLA has extended the range and duration of its submarine patrols, and one of its submarines escaped U.S. detection.[197]

During the Cold War the lifetime of an American carrier against a Russian attack - especially an attack involving submarines - was estimated at forty-eight hours. The PRC's acquisition of Russian weapons and training against U.S. carriers must be expected to shorten their operational lifetime in a battle.

In contrast to the PRC's capabilities which now would make it possible for them to threaten and attack U.S. aircraft carriers, the United States has not introduced new weapons or warships on the same scale as the PRC. It has not trained against an improved Chinese Navy using Russian weapons in the Taiwan Strait. It has not added to its number of aircraft carriers, counting itself fortunate, instead, to be able to maintain their numbers. Rather, the United States has retired a number of warships.

In the event of a PRC attack on the offshore islands of Kinmen and Matsu, and subsequently extending to the Pescadores, a U.S. response involving its aircraft carriers would be likely to be attended by grave danger in spite of optimistic assessments by the commander of the U.S. 7th fleet.[198]

The Middle East

Finally, there is one other factor that is often overlooked when assessing the PRC/Taiwan situation. This is the PRC's strategic alliance with Saddam Hussein. This alliance, formalized in a treaty at the end of 2000, marks an extension of PRC influence into the Middle East.[199] A PRC/Iraqi military alliance poses immense problems to any U.S. attempt to intervene to protect Taiwan in the event of an outright attack from the Chinese mainland. The outbreak of war in two diverse theaters that are geographically far removed from the United States would present a major problem to the U.S., requiring long support lines. Furthermore, a U.S. military response in the Middle East would

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have to take into consideration Saddam Hussein's possible possession of nuclear or other weapons of mass destruction, which would substantially effect the degree of the logistical stress.[200] The benefits to Saddam Hussein of his alliance with the PRC include improvements to his air defense, illustrated in the January 2001 U.S. bombing raids against Iraq where Chinese technicians were laying fiber-optic communication cables between Iraqi radar sites, control centers, and surface-to-air missile batteries.[201]

Through Saddam Hussein, the PRC has placed itself in a position of strategic advantage threatening the flow of oil from the Middle East to the Far East - Japan, Taiwan, and South Korea – as well as Western Europe and the United States. This would give the PRC substantial leverage in the event it decided to use force against Taiwan.

Ultimately, a U.S. response to defend Taiwan will depend not only on its perception as to what is vital for its own defense and its willingness to continue to support the PRC military build-up by an ongoing massive trade imbalance with that country, but also on its commitment to the rights of self-determination contained in the United Nations and Atlantic Charters. In addition to issues of American self-interest, at stake over Taiwan are the basic rights of independence, sovereignty, freedom, and the right of self-determination that marked the end of colonialism in Africa and Asia after World War II. Appeasement of the PRC over Taiwan would mark a new era of international tyranny – a fresh willingness to acquiesce in the use of force to subjugate free people.

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   Fourth, they will endeavour, with due respect for their existing obligations, to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity. . . .
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    The missile has a range of 65 miles and can deliver nuclear or conventional warheads. Chinese military writings have indicated that Beijing is working on weapons to defeat

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U.S. carrier battle groups. . . . The first Sovremenny destroyers arrived in China in February [2000], and the first shipment of 24 SS-N-22s this spring, said Pentagon intelligence officials. Bill Gertz, "Russia Readies Warship for China," The Washington Times, July 12, 2000.

China has purchased the Sunburn SS-N-22 missile (Moskit) from Russia, which will be fitted onto two Sovremenny-class destroyers also bought from Russia. The Moskits are reportedly designed to carry a nuclear warhead equal to 120,000 tons of TNT . . . Even with non-nuclear warheads, the Moskit is a very menacing weapon, traveling at 2 1/2 times the speed of sound, skimming along the water in a very low flight pattern, and capable of agile end-maneuvers to throw off defenses.

American military sources have stated that the Moskit is possibly the most lethal anti-ship missile in the world and that the U.S. Navy has nothing that can stop it. The navy's Phalanx system can detect the Moskit, but has less than three seconds to calculate a fire solution -- not enough time to stop the 750-pound warhead. The Sovremenny destroyers themselves were designed to "kill" aircraft carriers -- and aircraft carriers were exactly what Washington sent into the Taiwan Strait as a deterrent in 1996. June Teufel Dreyer, "Flashpoint: The Taiwan Strait," June 30, 2000. Reference: Charles Smith, "Navy to Get Russian 'Sunburn' Advanced Missile. Nuclear Warhead Version already in China's Hands," ChinaGate, 25 April 2000.

Sovremennys: The Chinese People's Liberation Army Navy commissioned its second Russian-built *Sovremenny*-class guided-missile destroyer, the *Fu Zhou*, at St. Petersburg on Christmas Day 2000 and is negotiating for the purchase of two more. Unlike the first two *Sovremennys*, which essentially were new ships, the second pair would be refurbished former Russian Northern Fleet units. A. D. Baker, III, "World Navies in Review," Vol. 127, No. 3, March 2001, U.S. Naval Institute *Proceedings*, p. 36.

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Adm. Robert Natter, commander of the U.S. Atlantic Fleet, mentioned China's growing anti-ship cruise missile threat during a meeting with reports this week. He suggested that China may be developing an advanced version of the Sunburn.

In discussing future Navy force structure and capabilities now under review, the four-star admiral asked whether the Navy wants to be able to confidently counter such threats. "The Sovremenny's in China come to mind," he said. "They've got a pretty good surface-to-surface missile on that ship. Can we counter it? Yes. Can we counter a supersonic grandson of that missile? I'm a little more worried about that." Bill Gertz and Rowan Scarborough, "China cruise missile," Inside the Ring, February 16, 2001.

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China's old diesel submarines are being phased out in favor of the indigenously produced Song SS. The Song is the first Chinese submarine equipped with a submarine-launched anti-ship cruise missile. China will upgrade two of the four Russian Kilo SS subs with improved quieting and sonar technology.
Senator Daniel Kahikina Akaka, ranking member of the Subcommittee on International Security, Proliferation, and Federal Services of the Governmental Affairs Committee who requested the congressional report, said that "the Untied States should not be complacent." Nadia Tsao, "China's 'new' navy poses a threat." Taipei Times, October 12, 2000.
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Arab Political Organizations within the Israeli State

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This article studies the political organization of the Arab minority in Israel up until the time of the recent disturbances. The primary concern of the article is to shed light on the development of Arab political organization and Arab political significance on Israeli politics. The paper examines four main research components: (1) nature and scope of Arab political organizations, (2) Arab-Jewish relations in Israel, (3) level and significance of Arab political organizations, and (4) impact of the Arab-Israeli conflict on Arab political organizations and Arab-Jewish relations in the Israeli state. Until the current year there were indications that Arab political influence within the Israeli state was becoming more evident. The future cannot be foreseen at the present time.

Key Words: Israel, Arab-Jewish conflict, Israeli Basic Law, Knesset, Mapai, Hadash, Likud, Israeli Labor Party, Israeli Communist Party, Histadrut, Azmi Bishara.

Since the declaration of the State of Israel in 1948, the Arab-Israeli conflict and the plight of the displaced Palestinians in Arab countries has attracted the attention of the whole world, particularly Arab and Muslim states. However, far less attention was given to the Palestinian Arabs who remained in Israel after the war in 1948. As the Arab-Israeli conflict took different forms after the wars of 1948, 1956 and particularly the Six Day War in 1967 and as the Arabs became able to see the concreteness of the idea of Jewish state in Palestine, the world started to turn its attention to the Arab minority. The Arab public and the displaced Palestinians had diverse perceptions of the "Palestinians of 1948", as they came to be called. Some believed they were patriotic because they remained in their lands, others claimed that they neglected the Palestinian cause by collaborating with and recognizing the "Zionist entity."

The Arab minority was culturally, socially and economically distinct

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from the Jewish majority in the Israeli State. The Arabs who remained after the war were Muslims, Christians and Druzes. Economically, they were mostly poor peasants and workers. Under the military rule (1948-1966) the Arab minority became an issue of interest to social scientists. Their social, economic and political organizations were of interest for many observers. Observers studied different features of the Arab minority. Among those features are the political development and organization of the minority. Political orientations and attitudes of the Arab minority were seen from different perceptions by observers. Among the observers are those who believe that, although politically fragmented, the Arab minority has been influential on Israeli politics.[1] Others observe that efforts to form an Arab political organization were blocked by the Israeli State and this has radicalized the minority's political behavior.[2] However, most scholars agree that many changes have occurred within the Arab minority in terms of political development, influence on Israeli politics, and attitudes toward the Jewish state, which all demand exploration and examination.

The aim of this study is to shed light on the political organization of the Arab minority in Israel up until the current breakdown of civil order. Thus the study seeks to examine: (1) the Arab minority's political development, (2) the scope and nature of Arab political organizations, (3) the Arab minority's relation vis-à-vis the Jewish state, and (4) Arab significance on Israeli politics. Background information about the Arab minority will first be provided before investigating into the nature and scope of different political organizations of the Arab minority in Israel. Historical trends in the Arab minority's perceptions of and attitude toward the Israeli State and the Israeli's attitude towards the Arab minority will be discussed.

Review of the Pertinent Literature on Minority Organization

The dismantling of empires, the end of colonization, and the breaking up of the Soviet Union, all contributed to the light of minorities in the newly independent states. Towards the end of the 19th century and the beginning of the 20th, ideas such as nationalism, statehood and self-determination attracted minorities worldwide. Minorities saw in those ideas paths to liberation from colonizers and empires, to the preservation of their cultures and to self-determination. As a result, conflicts erupted between ethnic minorities and the states in which they resided. The issue of minorities attracted many scholars who sought to understand the nature of minorities, the mutual relation

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between minorities and the state in which they resided, and possible solutions for minority problems. What is a minority and what do minorities call for?

Like many terms in the social sciences, the term minority lacks a general;y accepted definition. For this study Francesco Capotori's definition will be introduced. According to Capotori, "a minority is a group which is numerically inferior to the rest of the population of a state, in a non-dominant position, whose members possess ethnic, religious, or linguistic characteristics that differ from those of the rest of the population and who, if only implicitly, maintain a sense of solidarity directed toward preserving the culture, tradition, religion or language." [3]

Before the Second World War, minorities were not legally protected. However, in the post-Second World War era, protection of individual rights became a norm in many states, but this did not suffice to protect the rights of minorities, since minorities are collective entities. Gradual change began to take place in the perception of minorities from legal and human rights perspectives. In 1966, Article 27 of the Covenant on Civil and Political Rights in Copenhagen gave attention to the problem of minorities. The article calls upon all states not to deny the right of their minorities to "enjoy their culture and profess and practice their own religion or to use their own language." However, due to Cold War constraints no further legal development took place for the issue of minorities until July 1991 in the meeting that took place in Geneva, which was attended by experts on national minorities. Experts who attended the meeting agreed that the issue of minorities should become an international issue and not an internal issue of the states. Although minorities differ from one region of the world to other, most of them share some or all of the following objectives:

1) To achieve equality and non-discrimination
2) To preserve and develop their culture, religion and language
3) To seek self–determination.

Politically, some minorities struggle for secession; in less extreme cases, autonomy may be a demand for a given minority. The struggle may take militant action extending to terror (killing and injuring civilians), peaceful struggle, or both. The world has witnessed many struggles for the above objectives. Minorities are treated as underdogs;

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in some cases they are persecuted and denied access to the political system. Among the many minority conflicts worldwide, are: In the Middle East, the Kurdish minorities scattered in Iraq, Syria and Turkey; the Turkish minority in Cyprus; the Arab minority in Israel; in Africa, the Southern minority in Sudan and Coptic minority in Egypt; in Europe, the Basques in Spain and Corsicans in France; in North America, the Quebecois in Canada; in Asia, the Chechnians in Russia, Tamil Hindu minority in Buddhist Sri Lanka and the Tibetans in China. Many solutions for minority problems were formulated. Some scholars consider autonomy as a probable solution. Others have considered federalism as a solution. While every minority case has its nature and particular environment, a lot remains to be done and said for minorities, especially as the world enters its globalization era.[4]

Relevant Background Information

Declaration of the State of Israel

On May 14, 1948, David Ben-Gurion declared the State of Israel. Immediately afterwards, Arab troops entered Palestine and confronted the Zionist movement, which had begun to seize lands inhabited by Palestinians. The Arab states, namely Egypt, Jordan, Iraq, Syria and Lebanon, lost the war and a series of Armistices were signed in 1949.[5] As a result of the 1948 war, more than 700,000 Palestinians fled the country to neighboring Arab states. 160,000 Palestinians remained on their lands. Almost overnight, the Arab majority in Palestine became an Arab minority in the newly created Israel. This demographic change meant a transition from a majority status to an "ethnic, national, linguistic, religious and cultural minority" in a newborn Jewish State. The new minority lacked leadership, as the political and economic elite fled the country during the war.[6] The remaining minority was mainly of peasants and workers lacking the financial means to flee. Among the elite that fled are the lawyers, doctors, merchants and landowners.[7]

The Distribution of the Palestinian Arabs remaining in Israel

Palestinians that remained in the area that later became Israel were divided into three religious communities. The majority is Muslims (76 percent) and the minority is composed of Christians (14 percent) and Druzes (10 percent). Sixty percent of the Arabs live in Galilee, while the rest are distributed as follows: the Triangle 20 percent, Negev 10 percent, and other Jewish towns 10 percent. The Arab minority is concentrated geographically and set apart from the Jewish majority.

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Economically, the Arab minority comes from the lower classes in Israeli society. Most of them were villagers and workers. However, a middle class of professionals emerged in the last three decades. Politically, the minority rejected the Zionist nature of the Israeli State and looked forward to equal rights with the Jewish majority before the law. The Jewish majority viewed the Arab minority with suspicion. For them the Arab minority is "suspected for disloyalty."[8] Israel, according to 2000 figures, has a total population of six million, with an Arab community approximating one million. The Arab population has been increasing since the declaration of the Israeli State. From 160,000 or 12.5 percent of the population in 1948[9] to 997,000 in 2000 or 17 percent of the population.[10] The average Jewish birth rate per one thousand is 18.8 percent, while the Arab rate is 27.5[11]. The Central Bureau of Statistics of the State of Israel projects that by the year 2020 the Arab population will increase to two million at a high estimation. Although the Arab minority gained citizenship and became subjects of the Israeli State in 1948, they remained under military rule until 1966. [12]

Military Rule (1948-1966)

From 1948 to 1966 the Arab minority was placed under military rule. Many aspects of life in Arab areas were regulated by the state.[13] Arab movement was controlled and their political activity was repressed.[14] Attempts to form political groups, establish newspapers and organize demonstrations were defeated by the military governor. Despite the repressive measures against the Arab minority and the prevention of the Arab minority from engaging in political activity, large numbers of Arab votes were delivered to the Labor party and its "Arab Affiliated lists."[15] According to Kumarasawamy, "it is not accidental that the highly successful period of minority lists affiliated to Mapai (Labor party) coincided with the military rule over Arab areas" between 1948 and 1966. In 1963, a proposal to abolish the military rule was defeated by one vote, and strangely enough, three Arab MK's, who belonged to the Mapai minority list, opposed the proposal.[16] This example may reveal the relation between the military rule and Israel's political dictate on the Arabs through the "minority lists" which were the only political expression possible for the Arab minority. As it was trying to build its newly born state, Israel through the military rule aimed at controlling the Arab minority. Israel viewed the Arab minority from a security perspective. By 1966, the end of the period of military rule, Israel had consolidated its existence and military rule wasn't

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necessary, but the control over the Arab minority remained – taking, however, different shapes, as we shall see. The end of military rule created better conditions for Arab political activity. Founding of organizations began to take place but under the open eyes and close control of the state.

Nature and Scope of the Arab Political Organizations

After the Palestinian elite fled the country as a result of the war with the Jews in 1948, the Arab minority became leaderless. Under such circumstances, the Arab minority had no choice but to surrender to the new *status quo*. Arabs prior to 1948 had no political parties.[17] During this time, the only way available for the Arab minority to express its political and economic interests was through the "minority lists" introduced by Mapai.

The Arab Minority Lists

Israel's electoral system is based on proportional representation. This encouraged Mapai in 1949 in the first Knesset elections to introduce the "Arab minority lists," which are lists established for the Arabs and separated from the major party list, but organized by the party. Those lists were "created, financed, and controlled by Jews,"[18] and according to Smooha, these lists worked with the Israeli security.[19] Among the Arab minority lists of that period were: Nazareth Region Democratic List, Democratic Arab List, and the Farm and Development List. As parties of the Israeli Left perceived the Arab minority lists as an asset for the elections, parties of the Right were "indifferent." However, as the Communist Party in Israel began to attract more Arabs, the importance of Minority Lists began to decline. For example, the Mapai Arab list in 1949 got 51% of the Arab vote, but 21% in 1977. This decline in Arab attraction to the Minority Lists led Mapai to include Arab candidates on its party list. Mapai became the first Zionist party to place Arabs on its election lists.[20] The failure of Arab minority lists after 1966 may be attributed to the end of military rule, Arab identification with the Communist Party, and increased political awareness among the Arabs.

Israeli Communist Party

Joining together with anti-Zionist Jewish communists after the 1948 war, Arab communists participated in the Israeli Communist Party (Maqi). This party was the only non-Zionist party among Israeli parties.

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Leadership of the party remained in Jewish hands until the party split into two factions, Rakah and Maqi, in 1965. In Rakah, Arab communists played the major role in leading the party.[21] As a reaction to the dominant Zionist culture, Rakah was an attraction to the Arabs, as the only non-Zionist party.[22] One third of the Arab votes were given to Rakah in 1973. As a result, two Arabs and two Jews made it to the Knesset.[23]

Al-Ard Movement

The Al–Ard Movement was established in 1958 as the first all-Arab organization. Its immediate objective was to revive the Arab minority's ethnic existence and articulate its interests. The movement believed that the resolution of the Palestinian problem should be in line with the desires of the Palestinian people and should satisfy their interests and aspirations. Attempts to register the movement officially were defeated by the Israeli authorities. Israel labeled Al-Ard a "Nasserite Movement." However, the Al-Ard movement dissolved after internal conflicts about its position on the State of Israel.

After the dissolution of the Al-Ard, the Arab Academic Union was established. The union included students, graduates and professors. The union was considered as the "orphan" of the Ard movement. The union called for an end to Israeli confiscation of land, improving the status of the Arab minority, and the consideration of the Arabs in Israel as part of the Palestinian people and Arab nation. But, due to a hostile Israeli press, employment restrictions and harassment by the authorities, participation and attendance by the Arabs in the union was low.[24]

Independent Arab Political Parties

The Arab minority in Israel always sought to establish an organization to represent its political interests, but many attempts were faced with impediments. The state's measures and attitude toward Arab political activity and political and ideological splits within the minority, which lacked common political orientation and leadership, were major obstacles for the founding of an Arab organization.[25] Although Rakah played an important role in representing Arab interests, its Communist ideology nevertheless did not suit Arab nationalists and Muslims. The Communist Party in 1977 found the Democratic Front for Peace and Equality (Hadash), which included Jewish and Arab non-communists. The front's platform called for a peaceful resolution of the Arab-Israeli conflict and employed the 1967 border to separate two states, the

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Jewish state and the Arab Palestinian state. The front attracted many Arabs and was supported by more than one-third of the Arab population. However, its performance began to decline due to various factors, which may start with the Islamic revolution in 1979, to the breaking of the Intifada in 1987, and to the fall of the Soviet Union.[26]

In 1988, the first Arab political party was founded by Abdel Wahab Darawshe, a former Labor member of Knesset.[27] The "Arab Democratic Party" (ADP) sought to attract Muslim constituencies and "emphasized the party's Islamization."[28] In 1996, Ahmed Al Tibi, Yasser Arafat's advisor and supporter of the Oslo Accord[29], formed a new party called the Arab Union for Renewal. The major objective of Tibi is to support Labor's election to power, in the belief that Labor would advance the peace process.[30] In the same year (1996), the "Al-Tajammu Party" was founded shortly before the Knesset elections by Azmi Bishara. The new party included former members of the Communist Party, the Progressive Movement and the Abnaa Al Balad movement. Al-Tajammu defines itself as a "nationalistic party-in-formation" and its objective is to block the "Israelization" process of the Arab minority and calls for cultural autonomy and "de-Zionization" of the state.[31] Arab parties during elections enter into coalitions such as the United Arab List, which included the Islamic Movement (not itself a party, but an organization that participated in the 1996 elections) and the ADP and another list, including Hadash and the Arab Union for Renewal.[32] The founding of Arab parties opened new political horizons for the Arab minority and made the Arab minority's presence felt in the Jewish State. Although there are many political and ideological splits among Arab movements and parties, most of them share the following objectives:

1. Accept the State of Israel (or else they wouldn't be able to operate legally).
2. "De-Zionization" of the State in Israel.
3. Preservation of Arab culture.
4. Improve the socio-economic status of the Arab minority.
5. Support Israeli parties that seek to advance the peace process.

After shedding light on the nature and scope of Arab movements and parties in Israel, the study now will focus on the relation that governs Arabs vis-à-vis the Jewish State.

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Arab-Jewish relations in the Israeli State

Arab Perceptions of and Attitudes toward the Jewish State

Recognition of the Israeli State did not materialize among all Arabs, especially those who were Palestinian. However, perceptions of the State of Israel have been changing. The Arab minority in Israel has different perceptions of the Israeli State. For the Arab minority in Israel, the issue isn't a matter of recognition; rather, it is a reality with which they have to deal on a daily basis. Since the Palestinians became a minority in 1948, the recognition of the Israeli State and ways to deal with its existence have been controversial matters. According to Smooha, Arab attitudes toward the Israeli State fall into four categories:

1. *Accommodationists* - those who believe that they should adapt to the system and work to "extract" concessions from the state.
2. *Reservationists*- those who believe that they should negotiate rather than oppose and should search for a third way other than Zionist governing and anti-Zionist opposition.
3. *Oppositionists*- those who accept Israel as a state but call for the "de-Zionization" of the state. For example, the Communist Party.
4. *Rejectionists*- those who totally negate the existence of the Jewish

State and desire to replace it with a secular democratic state.[33]

These difference in perception created political fragmentation among the minority. Kaufman and Israel observe that as an ethnic minority the Arabs had to face a "strategic dilemma." There were three options before the Arab minority:

1. *The Incremental-Instrumental Option*-, which was that Arabs connect themselves to the Jewish majority and advance their interests from within. Arab minority lists and Arabs in Zionist parties are examples.
2. *The Ethnonationalist Option*- this option was followed by the Communist Party. whose main objective is an "egalitarian" society in which the Arab minority becomes integrated in society but not assimilated.
3. *The Strategy of Abstention*- similar to Smooha's Rejectionist Category, this calls for minimizing contacts with the Jews and working to become self reliant.[34] Two groups followed this strategy: "Sons of the Village", an ultranationalist Arab movement which

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neither recognized the Jews as a nation nor Israel's right to exist.[35] The second was the Islamic Movement, which opposes participation in elections, and rather concentrates on the internal affairs of the Muslim villages. This movement considers the Committee of Arab Mayors an Arab parliament.[36] However, we cannot view the above categories and options from a static perspective. The relation governing the Arab minority and the state in Israel is in constant change.

The Israeli State's Attitude towards the Arab minority

Since its formation, the State of Israel was meant to be a 'Homeland for the Jews," thus a "Jewish State", as it was labeled by its Zionist founders. However, the existence of a distinct Arab minority contradicted the nature of the state, leaving controversial questions unanswered. Who are the "Jews"? Are all Jews citizens of Israel? Can non-Jews be part of a Jewish State, and what is the nature of the relation between the state and its non-Jewish minority? This remains a major issue before the Israeli State. However, this is not directly relevant to the subject of the study, as we here seek to understand the attitude of the Jewish State toward its Arab minority.

According to Reich, "activities of the Arab community were regarded primarily as the concern of the Israeli security system."[37] For the Israeli government, the Arab minority was a security threat, which is why military rule was the form of governing in the early years of the Israeli State's formation. The Israeli regime made efforts to keep the Arab community divided. The regime encouraged confessional antagonisms and kinship-based conflicts.[38] The Israeli law forbids any organization to operate if its ideology negates the existence of Israel or Israel's Jewish character. The Al–Ard Movement (as has been indicated in the study) has been labeled a "Nasserite Movement" by the Israeli State. Israel refused to grant the movement permission to register officially. When the movement presented the case before a court in 1965, the court refused to hear the case. When the movement presented candidates for the elections to the sixth Knesset under the name of the "Arab Socialist List", the military government crushed its four candidates. Later the movement's publications were confiscated and the Supreme Court claimed that Al-Ard represented an "illegal association denying the very existence of the State of Israel."[39]

According to Lustick, when the military government ended in 1966, suspicion remained against the Arab minority. Arab departments were

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formed in all ministers' offices, a prime minister's advisor on Arab affairs was established, and the Arab department of the Histadrut (Trade union organization) was founded. The major function of these departments was to control independent Arab political activity. In 1980, Arabs from all Israel sent delegates to Nazareth for the purpose of founding an Arab political party, but days before the congress was to take place, the Likud government banned the meeting.[40] Due to the increasing political awareness and activity of the Arab minority in the 80's, the Israeli Basic Law was amended to emphasize that any individual who runs for the Knesset must recognize the State of Israel as a state for the Jewish people.[41] In 1993, a campaign was started by elements of the right-wing in Israel against Hashim Mahamid, the Arab MK of Hadash. Shahak's "Israel's Arab MK's in an establishment" article studies the factors behind the campaign. His article claims that the campaign was due to the fact that Mahamid was a member of the Knesset Select Committee for State Comptrollership and was banned from attending a committee meeting to study a report on the Shin Bet in April 1993. Shahak reports that the committee's chairman Den Tihon of Likud "announced that he would deny access to the report to anyone, unless Mahamid "voluntarily" undertook to absent himself from the committee meeting discussing it." The Labor faction in its turn claimed that Mahamid should accept Tihon's request or be removed from the committee.[42]

Political parties in Israel differ in their attitudes toward the Arab minority. Mapai introduced the "Arab lists" and then was the first party with a Zionist ideology to include Arab candidates on its lists. In 1953 the Histadrut opened its membership to Arabs. Parties of the extreme Right such as Motedet and Tsomet restrict their membership to Jews. In 1982 the Likud party of the Right opened its Arab department.[43]

Change in Attitudes

After Israel had consolidated its existence and the Arab minority became a significant political factor in Israeli politics, a change of attitudes began to take place in different aspects of Jewish-Arab relations.

In 1969, the Arab MK of Mapai, Serfeddin Zu'bai, was elected Deputy Speaker of the Knesset. In September 1993, a major development took place when for the first time in Israeli history an Arab, Ali Deeb Yehya, was selected Israel's ambassador to Oslo. After Ezer Weizman was assigned the responsibility in the government to

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"monitor" the affairs of the Arab sector, he fired Benjamin Gurayeh of the security service, who had also served five years as an advisor of the Prime Minister on Arab affairs, a post hated by Arabs. After that, Weizman proposed abolishing the post. The proposal was accepted by Shimon Perez, the Prime Minister at the time.[44] After Prime Minister Rabin told the Knesset in 1992 that the Israeli State "erred" in its treatment of Israeli Arabs, he abolished the post of Prime Minister advisor on Arab affairs and established a committee of directors-general to handle issues that concern the Arab sector.[45] Rabin in 1992 declared that his government will be supported by the two Arab parties. This support was crucial for Labor to stay in power. But Sharon of the Likud called for "de-legitimization" of the elections. In 1996 for the first time the Labor Party campaigned in the Arab sector.[46]

Relative change in the relation between the Israeli state and its Arab minority, increase in Arab political awareness, and the divisive and competitive politics in Israel, have all helped create better conditions for Arab organizations to increase their level of political significance. This we shall face in the next part of this study.

Level and Significance of Arab Organizations on Israeli Politics

In a general observation of the political activity of Arab organizations, we realize that Arab organizations' influence on Israeli politics evolved from a marginal influence to an active and significant one. Marginal political influence that characterized the minority's behavior in the first three decades of the Israeli State may be attributed to strict Israeli measures toward Arab political activity, lack of political awareness among the Arab minority, and political fragmentation and lack of a common Arab organization or leadership. The Arab defeat in the war in 1967 was a turning point in the political life of the Arab minority in Israel. The defeat showed the difficulty of change from outside, and thus the Arab minority became aware that prospects for change lie in its hands. During the military rule the Arab vote went mostly to Mapai through the minority lists. Arab influence at that time was marginal, due to the fact that Arab MK's did not control their vote and had to comply with their party's decisions. Gradually, Arab influence began to increase, especially in the 80's. Arab political activity became independent. Before the 80's, the Arab vote wasn't strategically aimed at meeting the interest of the Arabs. In the beginning of the 90's with the establishment of independent Arab parties, the Arab vote became a major factor in Israeli elections, thus increasing Arab

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influence on Israeli politics. This new Arab independent politics began to have its effect when in 1992 Prime Minister Rabin decided to receive the support of two Arab parties. Rabin in that year became Prime Minister, five votes from ADP and Hadash having been crucial. This support was also crucial for ratifying in the Knesset the Oslo peace Accord between Israel and the PLO in 1993.[47] Due to the importance of the Arab vote in ratifying the peace treaty, a chief rabbi issued a rule that "all laws that pass by the Knesset on the strength of Arab MK's were null and void."[48]

The 1996 Knesset Elections

Arab political participation in the 1996 Knesset elections was remarkable. Arab participation wasn't limited to Arab parties, but also to other Israeli parties. 40,000 Arabs registered as members for the Labor Party. The open primaries for Knesset candidacy drew 21 Arab candidates for the Labor Party.[49] For the first time in Israeli history, Arabs won nine seats in the Knesset. The Islamic Movement, after long following the strategy of abstention, participated in the elections. The Islamic Movement formed the United Arab List with the ADP. The second Arab list was a combination of Hadash (including Al-Tajamu) and the Arab Movement for Renewal. As a result, Hadash emerged as the 7th largest party in the Knesset. Hadash's agreement with Al-Tajamu gave this joint three percent of the total vote.[50] Political and ideological splits, however, among Arab parties prevented them from forming a unified list.[51]

A major political development for the Arab minority took place when on March 24, 1999, Azmi Bishara announced his decision to run as a candidate for Prime Minister of Israel. Bishara became the first Arab to run for the Prime Minister's office in Israel. It was clear that Bishara's chances of winning were nil, but he sought a political bargain with Barak, the Labor candidate, in the second round. Bishara's withdrawal and Arab support paved the way for Ehud Barak, who became Prime Minister.[52]

The Arab-Israeli Conflict and Arab Organizations

The Arab-Israeli conflict had and still has a major impact on Arab-Jewish relations in the Israeli State. The Arab minority's reaction at different stages of the Arab-Israeli conflict evolved from a marginal reaction, to acts of condemnation and demonstration, before becoming influential in the last decade. The 1967 Arab-Israeli war left its imprint

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on the Arab minority; but due to strict control on Arab movements and activity, the minority's political expression was limited. However, in the Yom Kippur War, six years later, Arab reaction began to change. Reich observes that "in the wake of the Yom Kippur War and with increased international standing of the PLO, the Arabs of Israel seemed to become more restive and politically aware."[53] As a result of the Yom Kippur War, and due to increasing Jewish religious enthusiasm, the National Religious Party was founded. Among other things, this increased the ideological divisions among Israeli parties, which created more room for Arabs to bargain politically.[54]

In 1979, Israel and Egypt concluded a peace treaty. Rakah immediately denounced the treaty and considered it a betrayal of the Palestinian cause. The National Committee of Arab Students and the Progressive Movement, as well as the professionals, demonstrated and published statements against the treaty.[55] After Israel's invasion of Lebanon in 1982 and the internal Israeli crisis over the consequences of the invasion, the Labor party (after the elections of 1984) considered forming a government with the tacit support of Hadash, but the crisis pushed forward a national unity government, and the agreement was aborted .[56] The beginning of the Palestinian uprising (Intifada) in 1987 increased Arab political activism. A year later the first Arab party was formed.[57] The Madrid conference and the beginning of peace talks created a favorable environment for Arab political activity. The Arab reactions to peace talks and treaties in most of the cases were positive. The Arab vote on the Oslo Accord in the Knesset is an example. Arab deputies were sent by the Israeli government on "Peace Missions" to Arab states to mediate with Yasser Arafat, King Hussein and other Arab leaders.[58] In 1996 after Israel's " Grapes of Wrath" in Lebanon, which led to the Qana massacre, Prime Minister Perez's image in the eyes of the Arab minority turned black. In an act seeking reconciliation, Labor campaigned for the first time in the Arab sector. The Arabs' choice, however, was limited, and they voted for Perez in an attempt to resist the coming to power of Benjamin Netanyahu or the formation of an Israeli national unity government.[59]

In 1999, Barak came to power as a successor to Rabin in the attempt to conclude a peace treaty. However, peace talks reached a deadlock, particularly on the status of Jerusalem and the return of Palestinian refugees. As peace talks were stalled between the Israeli Labor government and the Palestinian Authority and the gap was widening between both parties, a visit by Ariel Sharon of the Likud to

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Al Aqsa Mosque, a sacred and religious sanctuary for the Muslims, on September 27, 2000, triggered the beginning of the second Intifada. The Intifada has continued up to the time of writing. Barak in December 2000 resigned from office and called for elections for Prime Minister. Again Arabs sought to bargain politically, and Ahmad Tibi even announced his intention to run for the election of the Prime Minister. Barak's picture in the eyes of the Arab minority deteriorated due to the severity of the Israeli measures against the Palestinians of Gaza and the West Bank.

At times of crisis in the Arab-Israeli conflict, Arab political maneuver and influence was always limited. As we have seen, this was evident in 1996 when the Arab minority supported Perez in a failed attempt to prvent Netanyahu from taking office. A similar situation arose when Prime Minister Barak resigned and called for new elections. This time most Arabs decided to boycott the election in an attempt to "punish" Barak for measures taken against the Intifada. However, their boycott only helped pave the way for the victory of Ariel Sharon, a figure the Palestinians detest. Although Arabs did not gain politically in either instance, both episodes manifest the increased political significance of the Arab minority. As the Arab population in Israel approximates a million, with 10% of the overall vote, Barak started his political campaign with a visit to an Arab town in the northern town of Tira – aiming at reconciliation, urging the Arabs to "get over" the uprising and "restore this Arab-Jew Israel."[60]

The present Arab-Israeli conflict will leave a major gap in Arab-Jewish relations in Israel. The distance between the two communities has always widened in times of crisis and narrowed in times of peace. Although it is early to predict the future of the Arab-Israeli conflict, Smooha distinguishes between two perspectives on the nature of the relation between the Arabs and Jews in Israel in the event a peace treaty is concluded. First, the "Mutual Alienation" perspective sees that even if Israel withdraws from any of the occupied territories it will seek to preserve its position by attracting more Jews, and some claim that new Israel settlements are being built in certain locations within the occupied territories largely to house such settlers. This will lead Israel to deny Arab-Jewish equality and Arabs will have to move out of Israel into the Palestinian areas. The alternative or "Mutual Accommodation" perspective, which depends upon Jews and Arabs eventually "becoming more receptive and considerate of each other," envisions the possibility of enhanced democracy within the

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Israeli state, with Arabs and Jews sharing equal political and civil rights.[61] By the time this article appears in print, it may be better possible to foresee which of these two options is likely to prevail

Implications of the Findings

This study sought to examine the political development of the Arab minority in Israel, the scope and nature of their political organizations, the level and significance of political organizations and the effects of the Arab-Israeli conflict on Arab–Jewish relations in the Israeli State.

The study dealt with the evolution of the Arab political organization, starting with the Arab Minority Lists of Israeli parties to the formation of Arab independent parties. The performance and significance of Arab parties were discussed, and the following implications were found. Concerning the level and significance of Arab political organization, some observers may argue that the significance of Arab organizations on Israeli politics is marginal and others may argue that it is active and has substantial influence. However, the study revealed that while their significance has been evolving but their level of significance is relative and connected to the events they are dealing with. In internal politics, on those issues that usually divide the two major Israeli parties, Labor and Likud, Arab parties may well be of significance to one of the parties (in most cases Labor). With Arab support, Labor elected Chime Herzog President in 1983 and Shlomet Illel as speaker in 1984.[62] In issues that deal with the peace process and particularly the issues the Likud and rightist parties are diffident about, the Arab vote proved efficient. The Oslo Accord is an example where the Arab vote was crucial. However, at times of crisis in the Arab-Israeli conflict (Intifada, "Grapes of Wrath" and negotiations of the final status), Arab political significance is limited, since the gap widens between the Arabs and Jews as a result of differences in the perception of the crisis and its resolution. Israelis unite behind a conservative force in times of crisis, making it harder for Arab political maneuver. This was the case, for example, in 1996 when Arabs had no objective but to support Perez to office, but it was Netanyahu who made it. And in 2001, when the Arabs decided to boycott the elections, Arabs indirectly assisted Sharon. This implies that a peaceful environment is more likely to increase Arab political significance amidst the divisive and competitive politics in Israel. This may contribute to the advancement of the socio-economic and political interests of the Arab minority. However, the Arab-Israeli conflict remains to be the

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major variable governing Arab-Jewish relations in Israel.

End Notes

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Attracting Portfolio Capital Inflows: National Political and Economic Attributes of Emerging Markets

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The general objective of this study is to discern and examine the role of macroeconomic government policies as well as the economic and financial attributes of host emerging market countries in shaping the destination of portfolio investments. The study identifies key "location advantages" that must exist in order to 'pull" portfolio investment. Further, it highlights public policy recommendations for attracting portfolio capital as a source of capital for developing countries.

This study finds a direct positive correlation between portfolio capital inflows and improvement in macroeconomic performance in the host economies. Countries in the emerging markets that were able to generate fast economic growth, engage in extensive privatization program, and adopted a public policy posture based on opening their economies to international trade and capital inflows were more likely to attract foreign portfolio equity investments than those developing countries that did not undertake significant market-friendly macroeconomic stabilization and fiscal consolidation programs.

Key Words: Financial Markets, Emerging Markets, International Stock

Markets, Political Economy, Economic Policies

Portfolio investments involve purchase of securities and fixed income investments by foreign individual and institutional investors in the domestic or local bond and equity markets of host countries. In contrast to foreign direct investment (FDI), where foreign companies obtain managerial control and operate productive facilities in the domestic economy, foreign portfolio equity investments (FPEI) normally transact through purchase of shares of companies quoted on stock markets. Portfolio capital flows can also be distinguished from

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'sovereign borrowing' as well as private bank lending. 'Sovereign borrowing' involves banks lending capital to a government, and public enterprises enjoy an explicit government debt guarantee. Private bank loans entail lending by foreign banks to the domestic private sector, generally at short maturity.[1]

Foreign capital flows to the emerging markets of Asia and Latin America have revived considerably since the debt crisis of the 1980s. However, the magnitude and composition of these capital flows have shifted greatly. In the 1970s and 1980s, the bulk of capital flows to developing countries came through 'sovereign borrowing' by governments in the form of long-term syndicated credits arranged by groups of foreign banks.[2] Since the mid-1980s, foreign direct investment flows to developing countries re-surged. In contrast, since the early 1990s foreign portfolio flows (hereinafter referred to as portfolio equity investments or FPEI) have been used significantly by foreign investors to purchase stocks and bonds in the securities market of foreign countries. FPEI has generally grown over this decade, with flows trebling in 1993 compared to a year earlier. The dramatic rise in the interest of global investors in the emerging economies of Asia and Latin American is evidenced by the spectacular rise in the value of the stock markets of the emerging economies. Between 1986 and 1995, stock market capitalization in emerging countries grew at a much faster rate than market growth in the developed countries. The emerging countries' stock market grew more than ten fold, from $171 billion to $1.9 trillion. During this time frame the market share held by emerging countries in the world stock market increased by 300 percent, accounting for 11 percent of the global stock market capitalization.

The Mexican financial crisis of December 1994 caused a short-term decline in FPEI flows, primarily in FPEI to Latin America.[3] Investment flows resumed a few months later, and by 1996 the volume of new equity raised on international capital markets by emerging market countries increased in one year by 34 percent, or $15 billion.[4] This large increase illustrates the resilience of the emerging markets as an attractive destination for portfolio investments.

The general objective of this study is to examine the forces behind foreign portfolio capital inflows. This paper will evaluate the influences of macroeconomic government policies as well as the economic and financial attributes of the emerging markets in shaping the destination of foreign portfolio equity investments. This macro or societal level of analysis will reveal those emerging market public policies, economic and

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financial attributes, and national conditions that "pull" FPEI. As a result, we will learn about key "location advantages" that must exist in order to attract portfolio investment as a source of capital for emerging markets.

A variety of international "pull" factors play an important role for attracting foreign portfolio equity capital. These factors include the role of a national government's fiscal balance and tight monetary policies. Further, the host government's structural economic reforms, centered on liberalization of the financial trade sectors and the privatization of public enterprises and services, contribute to FPEI attraction as does the level of macroeconomic performance and the development of domestic stock markets.

Various factors influence the decision of international financial market participants, particularly institutional investors and fund managers, to choose some emerging market economies for investment and bypass others. The growing role of institutional investors as purchasers of emerging market securities and their ability to take advantage of the securitization of financial markets impacted the scale and composition of the capital flows to emerging markets in the 1990s. Institutional investors usually make investment decisions based on the analysis of risk and return characteristics of various emerging equity markets and relate these specific investment returns to the rate of return for the entire portfolio. Consequently, investors select securities across sectors, countries, and asset classes to ensure that certain portfolio diversification benefits are attained.[5] The obvious question to be answered at this micro level, then, is determining which risk/return profile is more likely to motivate institutional investors and portfolio fund managers to invest in the stock markets of certain emerging market countries and not others. These decision-shaping factors may be found by examining the importance of public policies of the national governments, the health of the economy and other societal factors in attracting FPEI to a particular country. This micro-level of analysis will identify those elements that international emerging market equity fund managers consider important determinants for making decisions whether to invest in a particular emerging market country's stock market.

Over the long run, those emerging market economies that have relatively well-developed local stock markets, making portfolio investment in local publicly traded firms possible, and experience among the highest rate of economic growth are likely to become more

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attractive destination for international institutional investors. This paper will elaborate on these and other critical 'societal' factors as determinants of the ultimate destination of foreign portfolio equity investments. In particular, this study will address a number of specific issues related to attracting foreign portfolio investments: the impact of financial and macroeconomic developments in the developed economies upon the magnitude of FPEI flows to emerging markets, the extent of greater diversification arising from the recent globalization of the international capital markets enabling portfolio investors to diversify holdings across countries and regions of the emerging markets, the role played by a host government's public policies in pursuit of financial liberalization and privatization and macroeconomic stabilization, and other economic and financial attributes in the host country creating an advantage for a particular emerging economy or emerging market region.

Policy makers in emerging market countries host to FPEI have been concerned about the perceived volatility of these portfolio flows, the potential threat of sudden withdrawal in particular, and the consequent negative impact on domestic economies. National political leaders understand that FPEI has great potential to contribute to economic growth because these flows enable the management of local enterprises to raise the necessary capital on local stock markets for expansion and growth. Economic growth can, in turn, improve welfare in the host country by enabling households to achieve higher levels of consumption. However, as the turmoil that rocked Asian equity markets in 1997–1998 and its two predecessors (the European Monetary System of 1992–1993 and the Mexican peso crisis of 1994–1995) have amply demonstrated, potentially undesirable effects also can occur. These include rapid monetary expansion, inflationary pressure, and the appreciation of exchange rates, etc. More importantly, there exists inherent problems to exposing local financial markets to the risk of sudden FPEI withdrawals.[6]

Mitigation against sharp reversals is necessary in making FPEI flows sustainable. Public policies and the state of the economy contribute to mitigating sudden reversals. As the issues raised in this study are addressed, some important implications for the public policy of national governments will be evident for addressing some of the concerns regarding the negative impacts.

A comprehensive perspective on the dynamics of portfolio capital flows must consider a broader theoretical framework encompassing the

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'international system' or structure level of analysis. This analytic level encompasses structural and cyclical factors at the level of the international financial markets. Such factors stimulate capital flows to emerging markets, facilitating access to global portfolio capital as an external source of financing for the newly industrializing economies of Asia and Latin America.

At the international system level, the international interest rate is among the most notable international economic 'push' factors behind foreign portfolio capital flows to emerging markets. According to the prevailing hypothesis, an inverse relationship exists between long-term interest rates in industrializing economies and portfolio investment in the fixed income segment of the emerging economies capital markets.[7]

When long-term interest rates in the West decline, the high yielding debt instruments in emerging markets become more attractive. Conversely, when rates are higher the emerging markets debt instruments became less attractive, as illustrated with the rise in US prime rate in response to the Federal Reserve tightening of monetary policy in 2000. The emerging markets equity, as opposed to bonds, respond in the same manner in the developing countries as in the West. The values of equities rise and equity markets respond positively to declining interest rates.

Other structural 'push' factors include: institutionalization of savings and investment in the West, in the form of $15 trillion under institutional fund management; securitization; the development of a wide variety of financial innovation; and several other fundamental structural changes in the global financial markets. New mechanisms also have been developed in the international capital markets for channeling FPEI to emerging markets. These global financial market structural changes include country funds, venture capital funds, American depository receipts, and global depository receipts.

Cumulatively, these financial structural changes have propelled capital flows toward emerging markets, and will continue to push such flows to the newly industrializing economies. Further, these changes bode well for the sustainability of FPEI flows in the long-term. As these international or global 'push factors' have been addressed in great detail in the literature,[8] this paper will not elaborate further on these international structural and cyclical aspects of portfolio capital flows.

II. Plugging into the System of Portfolio Capital Inflows:

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Host Country Attributes

The cyclical and structural factors at the level of the international financial markets outlined above stimulate portfolio capital flows to emerging markets, but these forces alone do not explain why portfolio capital flows to a small and select group of countries. Portfolio capital flows as an important external source of financing have only moved to the most developed newly industrializing economies of Asia and Latin America. As we shall see in this paper, several particular attributes endow certain location advantages on a select host countries and shape the final destination of capital flows.

On the whole, Asia and Latin America were the primary destination for portfolio inflows over the last decade. Between 1992 and 1993, investment flows to Asia increased by 560 percent and to Latin America by 230 percent. FPEI flows rose sharply to both regions in 1996.[9] The regional distribution of private portfolio capital flows has been closely linked to host governments policies of financial liberalization and privatization and to the macroeconomic performance of countries in various areas. According to an International Monetary Fund study this trend reflected "... an improved ability of investors to discriminate among countries according to the quality of policy and economic performance."[10]

Host government policies play a critical role in attracting FPEI. The emerging market countries' host governments pursuit of financial liberalization and privatization and macroeconomic stabilization affect FPEI flow. Countries and regions that have registered fast economic growth and have dynamic securities markets which offer a broad base for foreign equity investment are also the primary emerging markets destination for FPEI. Notable among these destinations are South Korea, Taiwan, Singapore, China and Hong Kong. Latin America, Mexico, Brazil and Chile also have been among the favored destination for the inflows of portfolio investments. Clearly the economic and financial attributes in the host country are important factors which serve to "pull" FPEI to a particular emerging economy or emerging market region.

The key "pull" factor playing a vital role in attracting foreign portfolio equity capital has been the rate of economic growth. Those economies with the fastest economic growth on a sustained basis over a period of three years or more have been the primary beneficiary of portfolio inflows. Preliminary supporting evidence of the role of rapid economic growth will be provided later in this paper. It is sufficient to

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note here that, according to IMF data, improvements in macroeconomic performance in the host economies have had a positive impact on attracting FPEI inflows. This improvement is defined as fast economic growth, privatization, and the switch to a strategy of market liberalization in the host country. Those developing countries which have established active and liquid stock markets are able to generate fast economic growth aided by national government policies strongly favoring privatization programs and economic liberalization. Developing countries with this rapid growth are more likely to attract portfolio investments.

Part of macroeconomic performance is dependent on a hospitable public policy environment for attracting portfolio capital. Specifically, those countries where government authorities engineered a switch to a strategy of opening their economics to international trade and capital flows have been more successful in attracting FPEI than those developing countries that did not undertake significant market-friendly macroeconomic stabilization and fiscal consolidation programs.[11]

As a general proposition, the stabilization program of fiscal balance and tight monetary policy, in conjunction with economic liberalization programs, helped create the conditions for reducing controls on the inflow of portfolio capital. These policies also led to large scale privatization of public enterprises and services, making it possible for international investors to take position in these enterprises as publicly traded firms. These policies were being adopted by governments throughout Latin America and Asia where countries in the past had shunned such policy posture in favor of protectionist and import substitution models of development. The new policy environment promised to increase economic growth, reduce uncertainty and expand opportunities for foreign investors. This environment, in turn, created the need to tap the international markets for capital, as Pill has observed:

> "With profitable opportunities opened to private entrepreneurs by the liberalization of administrative control, demand for the financial resources to implement investment project increased. Moreover, individuals anticipated the beneficial effect of the reforms on economic performance and wished to borrow against their expected higher future income to permit greater current consumption. Where greater demand for credit could not be met out of the pool of domestic savings, the international capital markets had to be tapped,

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resulting in net capital inflows."[12]

Governments in emerging markets have been prompted to engage in liberalization and privatization, in part, because central banks wished to build up foreign exchange reserves. The ultimate objectives of central banks in the Asian and Latin American countries have been to prevent nominal exchange rate appreciation in the face of substantial capital inflows and to build up a 'buffer' against a sudden reversal of capital inflows. Of the $1.2 trillion in net capital flows to emerging markets during 1990–1996, $575 billion (49 percent of inflows) was accumulated as foreign exchange reserves. In Asia, foreign exchange reserve accumulation accounted for 70 percent of inflows, and in Latin America, 37 percent. This routing of capital flows into emerging markets and their recycling through investment in mature market securities in turn forced emerging market countries national governments to opt for policies of fiscal balance.

Similarly, national governments in the emerging markets countries relied in the 1990s on bond issuance as opposed to bank lending which was common in the 1980s. National governments issued bonds to restructure existing liabilities at improved terms (such as the repayment by Mexico of obligations to the United States and the partial repayment of its obligations to the IMF).[13] However, in order to secure international credit worthy ratings, which is usually a prerequisite for the issuance of such bonds, national governments in the emerging market countries opted for reducing budget deficits and foregoing expansionary policies that could increase the prospects for inflation.

In addition to the above factors, which forced governments to adopt policies of liberalization and privatization, there was a noticeable shift in the host countries developmental strategy. Throughout the 1970s and early 1980s, several major emerging market economies – notably South Korea, Indonesia, Brazil, Argentina, Mexico, and India – had relied on economic strategy of import substitution to boost the export of inefficient industries. By the late 1980s, the countries in Asia and Latin America had largely abandoned such inward-looking models of development in favor of structural economic reforms centered on macroeconomic stabilization and liberalization of the financial and trade sectors and the accumulation of foreign exchange reserves. These reforms were due partly in response to public policy postures encouraged by the IMF, World Bank, and American government, and partly motivated by the previously-mentioned desire by the host

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government to attract foreign capital to build up foreign exchange reserves as a 'buffer' against a sudden reversal of FPEI capital flows. The economic stabilization programs were based on fiscal balance and tight monetary policy, and the financial liberalization programs entailed loosening of capital controls and the privatization of public enterprises and services. The new policy environment promised to increase economic growth, reduce uncertainty, and expand opportunities for profitable investment. This environment, in turn, increased the need to tap the international capital markets for capital.

The shift to a public policy posture of opening national economies to international capital flows and trade was best reflected in the decision of national governments in major Asian and Latin American countries, including those mentioned earlier, to loosen a variety of restrictions on capital flows. Specifically, the following types of restrictions were either phased out or drastically reduced: capital account restrictions, bilateral payments with IMF members, advance import deposits, import surcharges, current account restrictions, surrender of export proceeds, restrictions to purchasing stocks in local companies, and provisions regarding repatriation of income.

The correlation between a national public policy posture of liberalizing capital account restrictions and capital inflows is best illustrated by an IMF study on the impact of capital control on the inflows of capital. In this study, an aggregate index was constructed correlating capital control to whether a country restricted capital account transactions, used multiple exchange rate practices, or enforced surrender requirements for export proceeds. The index varies between zero and one, with zero representing a complete lack of control ranging to the value of one where all three limitations exist. The limitations are defined as restrictions on capital account transactions, use of multiple exchange rates, and rules of enforced surrender for export proceeds. The study finds that there has been loosening of controls over capital flows in emerging markets since the mid-1980s. Further, it indicates that the decline in capital account restrictions have facilitated the recent boom in capital flows to emerging markets. The hypothesis that a direct positive correlation exists between the liberalization of capital controls by emerging market governments and the ability of these emerging economies to attract foreign capital.[14]

One dramatic piece of evidence is seen in Mexico. Starting in the late 1980s, political authorities in Mexico completely liberalized the capital account of its balance of payments. As a result, Mexico

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experienced a huge influx of portfolio inflows and foreign- denominated credits to Mexican banks. At its peak in 1992–1993, portfolio capital inflows accounted for 5.5 percent of the gross domestic product (GDP). International investment banks invested heavily in Mexican stocks, money market instruments, and government denominated debt instruments.[15]

Significant implications for equity capital inflows are also apparent in the liberalization of regimes regarding the purchase of securities in domestic publicly traded enterprises by foreign institutional investors and their ability to repatriate dividends, interest, and realized capital gains. Such liberalization addressed repatriation of capital gains and dividends, a key concern of institutional investors regarding investment in the securities of emerging markets firms. However, liberalization regarding repatriation and capital accounts is not complete, as data by the 1998 International Finance Corporation study reveals. The study found three emerging markets as 'free' with respect to foreign equity investment listed on local stock exchanges. The majority of the markets were characterized by some degree of restrictions that hamper the free flow of portfolio capital or could only be considered 'relatively free.' However, one market remained closed to foreign investment.[16]

As noted earlier, the economy in the host emerging market countries plays a vital role in the regional distribution of private capital flows (or the final destination of FPEI). Fast economic growth together with portfolio investment-friendly policies of national government and a liquid stock market which makes entry into and exit from equities possible create an attractive environment for portfolio equity investment inflows. Capital flows in the mid-1990 re-surged, reflecting clear recognition by foreign investors, institutional investors in particular, that fast growing economics in Asia and Latin America and the development of stock markets in selected countries presented opportunities for capital gains of emerging economies' publicly traded enterprises.

Investors increasingly came to accept vastly improved economies in most emerging markets in the 1990s, as compared to the 1970s and the 1980s. Many developing countries in these earlier decades relied on import substitution as an important component of development strategy, thereby using capital inflows both to finance large fiscal imbalances and to offset the affect of capital flight. Import substitution reliance was particularly used by emerging market nations in the period through the 1970s and 1980s. The resulting fiscal imbalances often

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contributed to rapid inflation and a highly overvalued exchange rate. In contrast, the 1990s brought an economic growth strategy to many emerging markets that emphasized opening their economies to international trade and capital transactions, fiscal consolidation, inflation stabilization, and extensive structural reforms designed to improve overall efficiency of the countries' economies. Moreover, these changes took place against a background of a stable macroeconomic environment in the mature markets.[17]

A combination of positive changes in macroeconomic performance occurred in the 1990s making these newly industrializing economies highly attractive for portfolio investors. Notable macroeconomic performance indicators propelling FPEI were: declining fiscal deficits and inflation, surge in exports causing a decline in the ratio of external debt to exports, and dramatic improvement in the real rate of output growth and the corresponding decline in the ratio of external debt to GDP. Emerging market countries saddled with a debt-servicing problem saw the fiscal debts fall from an average of 6 percent of GDP in 1983 to 3 percent of GDP in 1990-1996. The rate of inflation dropped from 177 percent annually in 1979-89 to 19 percent in 1996. During that same period, economic output for this group of countries with debt-servicing problems rose from 2.2 percent a year in the period 1979-89 to over 6 percent in the period 1990-1996. Further, exports nearly doubled during this period, and led to a major decline in the ratio of exports to debt service. As a result, Standard and Poor's and Moody's Investment Services, two premier credit rating agencies, upgraded the rating of these countries. These economic growth and performance characteristics did not go unnoticed by portfolio equity managers and investors who pay close attention to economic growth, macro economic stability, and economic rating of countries.[18]

According to some accounts, the relationship between economic growth and capital mobility is strengthening. Fast growing economies tend to attract international capital. Free international capital movements, in turn, benefit the economy in several ways. Agosin has summarized these benefits as following:

> "First, developing countries will gain access to international saving, allowing domestic investors to tap new sources of funding and, to the extent that firms face financing constraints on investment, increasing the investment rate. Second, the cost of borrowing will decline, as interest rate in international financial markets tend to be

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much lower than domestic rates. As a result investment and growth will increase. Third, international finance can help a country smooth its international pattern of consumption. When a country is open to international financial flows, it no longer has to finance an increase in investment with a commensurate increase in domestic saving (and, hence, a decline in consumption). Instead, the country can rely on foreign savings, which it can repay from higher future incomes."[19]

The World Bank data tend to provide preliminary support for these benefits. Between 1985 and 1994, the World Bank reported that real economic growth in the 37 developing countries averaged 3.2 percent – more than twice the average in developed countries over the same period. Further, the gap in economic performance between the group of countries that liberalized their capital markets and those that have not tends to be wider. The 80 or so developing countries (excluding the former Soviet Union and Eastern Europe) that did not significantly liberalize their capital account actually shrank by an average of 0.3 percent during 1985-1994. In fact, Africa and other regions lacking liberalization policies experienced capital flight in the 1980s.[20]

III. Microanalytic Dimension

One of the most important yardsticks to judge the importance of economic growth factors for portfolio inflows is the reaction of financial market participants to emerging countries' market attributes. Investment decisions by international financial market participants, portfolio fund managers, and institutional investors in major financial markets, such as Wall Street, consider a mix of investor-friendly public policies and a relatively liquid local stock market as determinants of portfolio inflows. The appropriate mix is vital to their decision to enter the equity market of a particular emerging market country.

The ability, willingness, and decision of institutional investors to discriminate among countries as targets for portfolio investment has been in part a function of the rate of economic growth, the quality of macroeconomic policy of national governments, policies governing local stock markets and financial liberalization, and the relative liquidity of local stock markets. This micro-analytic level is in effect the nexus between the micro-enterprise and the macro state/society level 'pull factors.' This section will elaborate on the importance of these attributes in shaping the decision of international financial market participants, institutional investors, and fund managers to choose the

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enterprises in a particular country or region for equity investment

Investing in overseas equity markets is central to diversifying a portfolio to manage risks. However, to identify and take advantage of higher rates of return from overseas equity markets, the rate of economic growth is a key factor in decision making. Specifically, fund managers who deploy a 'growth investing' style – that is, giving greater weight to the growth in earnings of prospective enterprises and being willing to pay higher price earnings ratio adjusted for growth to take position in the equities of these enterprises – look to fast growing emerging economies as sources of investment opportunities. Fast growing macroeconomic environments provide greater opportunities for substantial earnings (or net income growth) from investing in fast growing publicly traded companies.

Preliminary data tend to support this view. Expected return on emerging markets' equity-price-earnings ratios adjusted for growth rose steadily during 1996 and into 1997, buoyed by upward revisions in the forecast of both firm-level growth and national economy growth in certain emerging market countries. Adjusted for volatility, equity returns looked increasingly favorable relative to mature Western markets. These returns were particularly favorable in Latin America and in Asia until the Asian financial crisis of 1997–1998. For example, the International Finance Corporation's Investable (IFCI) Composite Index, which tracks 1224 stocks in 26 emerging market counties with a weight of 47 percent for Asia and 33 percent for Latin America, showed that total dollar returns in 1997 reached 9.5 percent. This collective return was well in excess of the Standard and Poor's 500 index (an index of 500 large and medium capitalization stocks in the United States equity markets) of 2.7 percent. In 1996, Latin American and Asian markets had total returns of 17.2 and 10.5 percent, respectively.

The data also bears out the importance of macro economic growth as a key factor that induces portfolio managers to favor one country or region over another, and shift portfolio capital accordingly. In 1997, Latin American markets returned a robust 15.2 percent on investments. In contrast, due to the Asian financial crisis, returns in Asian markets that same year fell to 1.2 percent. Investors responded with a shift away from Asia in 1997 and 1998 to other emerging market regions. The primary reason for the shift perception by international financial market participants, global fund managers in particular, was that the economic slowdown in Asia would lead to a relatively lower economic

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growth for the foreseeable future as the economies matured. In contrast, as the economic fundamental in Latin America improved, projections for economic growth in these areas were revised upward. International investors, therefore, were willing to pay a higher premium for increased economic growth and faster corporate net income growth in the form of a higher price to earning ratio.[21]

The vital role of investor-friendly national macroeconomic policies was noted earlier. Institutional investors have a preference for liberalization of various rules and regulations governing purchase of securities. These investors are concerned about weak regulatory frameworks regarding corporate financial data, and prefer greater transparency and uniformity in accounting standards to aid evaluation of the quality of cash flow, balance sheet and income, and the future earnings growth prospects of potential investments. Governments that engaged in preliminary reforms in these areas – notably Hong Kong, Singapore, South Korea, Taiwan, Brazil, Israel, South Africa, and Chile – were able to win a modicum of international investor confidence in the securities markets of these countries, and thereby made it easier for local financial markets to attract portfolio capital. An example is the liberalization of national rules regarding equity transactions. Foreign institutional investors purchasing securities in domestic publicly traded enterprises were able to repatriate dividends, interest, and realized capital gain, and the inflows of portfolio capital benefited from this liberalization of regulatory regimes in the emerging market countries. These changes had significant positive implications for equity capital inflows.

In addition to the vital role that public policy posture plays in encouraging FPEI inflows through economic stability and economic performance, the host country also must support a stock market sufficiently developed to meet the minimum needs and standards of FPEI investors, institutional investors in particular. Equity portfolio investors are interested in high risk-adjusted returns on their equity investments. The degree of market liquidity is another vital factor that shapes decisions to invest in emerging markets. Market liquidity can be measured by several factors, including an adequate market infrastructure for trading securities, the availability of an exit mechanism through stock exchanges to withdraw capital when necessary, and a relatively broad base of investment options so that the selection of available investment choices are not severely limited.

The importance of a developed stock market helps explain why

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FPEI flows have been heavily skewed toward a small number of major emerging market countries. FPEI is seen to flow toward countries with established stock exchanges with the largest market capitalization, market liquidity, and some level of government regulation regarding information-disclosure and accounting standards. The major emerging markets with these economic and financial market characteristics are South Korea, Taiwan, Hong Kong (province of China), Singapore, Mexico, Brazil, South Africa, Turkey, and India.[22]

IV. Reversal of Portfolio Capital Inflows

Global capital markets are inherently unstable, as the dramatic reversal of portfolio capital during the Mexican crisis of 1995 – 1995 and the Asian financial crisis of 1997 – 1998 have demonstrated. Rapid changes occur where vast amounts of portfolio investments or 'hot money' can move around the world in seconds. One authoritative analyst has observed that financial markets involve maturity transformation, and relying on the law of large numbers of independent, imperfectly correlated transactions. However, 'when something signals all individual transactors to move in the same direction in the same short interval, the basic fragility of any financial system is revealed.'[23]

These crises also reveal the quick "spillover" or contagion effect from weakness or crisis in one economy spreading to others as investors perceive similar vulnerabilities. The 24 November 1997 issue of *Fortune* reports that during the course of the prior two months, Thailand's currency had lost 58 percent of its value, Malaysia 32 percent, Taiwan 12.1 percent, South Korea 14.3 percent, the Philippines 33.4 percent, Indonesia 53 percent and Singapore 12.3 percent. Declines in the market capitalization of stock exchanges mirrored currency declines. During the fourth quarter of fiscal year 1997, Hong Kong's stock exchange was off by 20 percent, Thailand 45 percent, Malaysia 46 percent, South Korea 28.3 percent, the Philippines 42.5 percent, Indonesia 21.6 percent, and Singapore 28.7 percent.

International financial markets, institutional investors, and fund managers respond quickly to perceived policy uncertainties, structural weaknesses, deteriorating economic fundamental in the macro economic environment, and the sales and earnings of local enterprises in which hot money is invested. These quick responses were demonstrated in the spillover effects from Mexico in 1995 and the events in Thailand and in the Czech Republic in 1998. These crises

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also reveal the willingness of participating financial market investors to 'test' the authorities' exchange rate commitment when weaknesses in policies are perceived.

These financial crises, along with their consequences for emerging market economies, and public policies designed to counteract or reduce their negative effects have been addressed in great detail elsewhere in the literature. Some accounts of financial crises seek to explain these events with reference to technological and market forces.[24]

Several prominent political scientists, notably Heilleiner and Ruggie, emphasize the behavior and interests of states as important determinants of the globalization of financial markets.[25] Sachs, Fiestein and Horioka, Calvo and Leiderman are among the leading scholars in international economics and international business who stress the importance of financial and economic causes of capital flows and currency crises.[26] In this paper, we will highlight three key issues: First, those economies that experienced sharp portfolio reversal suffered from severe structural economic problems. Once revealed, these problems triggered portfolio capital reversal. Second, sharp reversals in portfolio capital cannot be solely attributed to domestic economic weaknesses and public policy mistakes. Financial market participants' behavior, the short-term investment horizons of portfolio investors in particular, also plays a role. Moreover, it stands to reason that emerging market economies with the highest rate of exposure to portfolio investment are likely to experience more severe capital reversals compared to those countries with limited exposure. Finally, large scale portfolio capital reversals may cause short-term economic dislocations. However, such reactions of the international financial markets serve a beneficial purpose. These events force domestic economic reform on national governments and on local enterprises.

All major emerging markets economies suffered from certain structural weaknesses in need of dire economic reform. Although there are differences in the kind of economic challenges each country in the region faces, each required some structural changes. Asian economies provide ample evidence. In South Korea, for example, the challenge has been to restructure the troubled *chaebol* (large conglomerates such as Samsung and Daewoo), open financial markets to foreign investors, and recapitalize banks battered by corporate bankruptcies. Further, South Korea needs to rationalize its corporations by freely allowing mergers and acquisitions. The Philippines, on the other hand, needs to keep a lid on inflation. Indonesia, Malaysia and Thailand are among

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the shakiest of the Southeast Asian economies. All three suffer from endemic system-wide economic problems involving high debt and overcapacity. Indonesia, similarly to South Korea, needed to swallow the IMF's medicine to cut the national budget. President Suharto's 'kleptocracy' was slow to act, consequently triggering a political crisis that led to the downfall of the regime. The challenge for Thailand has been to reduce the trade deficit, put brakes on consumption, move toward more value-added capital-intensive businesses and adopt constitutional reforms to stabilize the government. Malaysia has to reduce both public and private debt. All countries in the region, perhaps with the exception of Singapore, need to deregulate their economy and tighten monetary policy so as to squeeze out excesses in the real estate sector in order to cool this overheated segment.

Second, the reversal of capital flows cannot be wholly attributed to misguided and misaligned macroeconomic policies of national political authorities and to weak economic fundamentals of the local economy. It stands to reason that large capital inflows today may set the stage for large outflows in the future. One authoritative study suggests that sudden flight might be triggered by circumstances beyond the control of policy makers.[27]

In addition to the size of capital inflows, its composition is an important factor. Specifically, one needs to distinguish between portfolio capital (short term flows in the form of equities, short-maturity bonds, and deposits in local banks), and foreign direct investment. The latter is motivated by the desire to access markets and resources, and it has a long-term investment horizon. In contrast, portfolio investment is motivated by participation in the earnings of local enterprises through local capital gains and dividends. It tends to have a short horizon and is more volatile than FDI flows. In a world of fickle private capital movements, a sudden and sharp reversal in large flows of these short-term portfolio investments can occur in response to the latest investment style or to the mood of Wall Street institutional investors, portfolio managers and traders. This combination of excessive capital flows and its short-term composition helps explain why, for example, the 'Asian contagion' did not spread to Bangladesh, Pakistan and other poor developing countries, and why these nations did not experience currency crises. The spread was avoided in spite of the fact that current account deficits, bulging budget deficits, overvalued exchange rates, fragile banking and financial systems and other economic fundamentals were worse in these countries than Asian

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countries such as Thailand, Indonesia and Korea. The amount of short-term portfolio capital in these countries was small compared to the large emerging markets economies of Asia.

Preliminary evidence on the size and composition of short-term capital flows lends support to this argument. The distribution of portfolio equity and bonds investment is skewed towards upper-middle income countries. These countries offered investors and financial speculators a broader base for investment, market liquidity, and exit mechanisms in the form of established stock exchanges. In 1996 the volume of new equity raised on international capital markets by some of the leading emerging markets (South Korea, Malaysia, Singapore, Taiwan, Hong Kong, Mexico, Brazil, Argentina) increased by 34 percent over 1995, or $15 billion, illustrating the resilience of the newly industrializing countries as an attractive destination for portfolio investments. Between 1986 and 1995, stock market capitalization of these countries rose more than ten fold, from $171 billion to $1.9 trillion. By the end of 1995, 17000 companies were listed and traded on the stock markets of these leading emerging markets countries.[28]

We should however, add caution to observations regarding the role of imperfect markets and market failures. A study by Jeffrey Sachs, the eminent Harvard economist, reveals the level and composition of short term capital inflows indirectly affects the likelihood of financial crises through affecting the real exchange rate. In 1993, for example, countries that came under attack – Argentina, Mexico, and the Philippines – had average short term flows of 1.4 percent. In contrast, Chile absorbed more of this 'hot money' (3.5 percent of GDP), yet avoided a currency crisis or sharp reversal in currency and remained unscathed.

Finally, such crises result in economic reforms. The financial crises in the emerging markets' economies, triggered by sudden and large scale reversals of portfolio capital, has and will continue to force much needed economic reforms. In Asia, the crisis has accelerated the dismantling of a system that emphasized a disproportionately large role for government-directed investment. Whenever serious mistakes arise from government-directed or influenced investments, private global capital flows will become adverse, exposing misguided policies and domestic structural and institutional flaws of the system. In the case of South Korea, for example, the government sometimes provided support for ailing companies that should have gone bankrupt, and the nation extended loans and guarantees to private firms driven, not by market

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forces, but by a national 'industrial policy.' In many of the Southeast Asian countries facing the current economic and financial crisis, such government loans led to misuse of resources, unprofitable expansions, losses, and eventually loan defaults. When government guarantees those foreign currency-denominated loans, as had been the case in some of the Asian economies, it makes national government vulnerable to the backlash of financial markets.

The renewed surges in portfolio equity flows have been directed to a select group of countries in Asia in the aftermath of the Asian crisis. As recent attempts at reform continues along the lines specified earlier, positive international investor response is seen to these structural reforms, especially in South Korea, and to the sustainability of these reforms in spite of short term volatility.

V. Research and Policy Implications

A set of specific economic, public policy and financial environment characteristics exist in a particular country and region, serving to 'pull' capital inflows and shape the direction and final destination of portfolio equity investment. Among these characteristics, several national factors play an important role for attracting foreign portfolio equity capital. Key national factors are the rate of economic growth, international investor-friendly macroeconomic and public policy posture, and an established liquid stock market that offers portfolio investors the ability to take significant positions in the equities of publicly traded enterprises and to exit such positions. Those newly industrializing economies that have experienced the fastest economic growth have attracted portfolio inflows. These 'pull' conclusions can be stated in the form of two primary and two subsidiary research hypotheses, which can then be rigorously tested and analyzed:

Primary Hypothesis One: There is a direct positive correlation between FPEI flows and improvement in macroeconomic performance in the host economies. These improvements are fast economic growth, privatization and the switch to a strategy of market liberalization in the host country. Countries in the emerging markets that were able to generate fast economic growth, engage in extensive privatization program, and orchestrate a switch to a strategy of opening their economies to international trade and capital flows were more likely to attract FPEI than those developing countries that did not undertake significant market-friendly macroeconomic stabilization and fiscal

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consolidation programs.

Subsidiary Hypothesis: The regional distribution of private capital flows (or the final destination of FPEI) is closely linked to the macroeconomic performance of emerging market countries, in particular the ability of institutional investors to discriminate among countries according to the quality of economic policy and economic performance.

Primary Hypothesis Two: Institutional investors are motivated to allocate assets under management to the emerging markets. This motivation comes from the search for high yields and the desire to take advantage of capital gains opportunities presented by undervalued financial assets and by dividends (all key features of mature financial markets), while diversifying market risks.

Subsidiary Hypothesis: The resurgence of capital flows also reflects clear recognition by investors, institutional investors in particular, that fast growing economies in Asia and Latin America and the developments of the stock markets in selected countries present opportunities for capital gains of the equity of emerging economies' enterprises listed on local stock exchanges.

The fundamental premise underlying the last three hypotheses is that portfolio investment in emerging markets was in part a function of acceptance by foreign investors, portfolio managers in particular, that the economic fundamentals of targeted emerging markets countries have vastly improved in the 1990s compared to the 1970s and the 1980s. In these earlier decades, many developing countries, especially the heavily indebted emerging market states, relied on import substitution as an important component of development strategy, and used capital inflows both to finance large fiscal imbalances and to offset the affect of capital flight. Such fiscal imbalances often contributed to rapid inflation and highly overvalued exchange rates. By contrast, in the 1990s a broad set of emerging markets switched to an economic growth strategy that emphasized opening their economies to international trade and capital transactions, fiscal consolidation, inflation stabilization and extensive structural reforms designed to improve their economies' overall efficiency. Moreover, these changes took place against a background of a stable macroeconomic environment in the mature markets.[6]

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In addition to the theoretical implications embedded in the hypotheses stated above, this study reveals several other public policy implications. First, in this competitive global financial market place, the governments which will fair best in attracting portfolio investment as a source of capital for economic development are those which run a tight monetary policy and maintain fiscal balance, engage in liberalization and transparency in the financial markets and trade sectors, are committed to privatizing public enterprises and services, and are developing domestic stock markets.

Second, global financial market participants, fund managers, and institutional investors have a vested interest in the improvement of standards of disclosure, accounting, and providing greater transparency in a well-regulated equity market that offers ample investment liquidity. As a group these actors are likely to be a source of pressure for change on host governments for reforming equity markets in the emerging economies, and for greater financial and market transparency and liberalization. Likewise, these institutional investors have been the primary transnational constituency pushing the American government, IMF, and World Bank to put pressure on emerging governments to adopt higher standards of disclosure.

As a group these global financial actors are in charge of managing and deploying financial assets currently estimated to be $20 trillion, and estimated to grow to $35 trillion by 2015. Just one percent of these assets in the form of equity investments, when deployed in the emerging markets in the 1990, was greater than all capital diffused in the form of bank loans and sovereign lending to the developing countries during that decade. Therefore, it is not surprising that these actors wield great power. Indeed, the power of these global institutional investors vis-a-vis national governments in the emerging markets and developing countries stem from the huge amount of dollars being wielded which will not flow to private enterprises in these countries without greater disclosure standards, financial liberalization, and a regulatory infrastructure for local stock markets. Since domestic firms in developing countries in which these global investors take investment positions will continue to become the beneficiaries of such flows, these local firms, in turn, are highly likely to become a major local ally and a force behind further financial liberalization in the emerging markets and in those developing countries that wish to attract FPEI.

International investors are sensitive to fiscal policies. Their goal is

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to realize and transfer a substantial portion of the appreciation in value of the stock of firms in which the funds are invested, including high yielding government or private denominated debt instruments (or bonds). Governments in the recipient country that seeks FPEI inflows as a source of capital for development are advised to provide investors with an attractive tax regime. Those type of portfolio investors taking a higher investment risk, notably venture capitalists who invest in highly risky and yet unproven enterprises, expect higher rates of return on invested capital than the historical average of 12 percent associated with investing in equity markets.

Third, national governments in emerging markets countries wishing to attract FPEI, should make a sustained effort to provide a well-regulated stock market, one that allows capital to exit. One key factor that entices FPEI inflows, particularly venture capital, is the availability of 'exit' options, allowing institutional investors to sell their stock and bond positions, repatriate their capital, and thus 'exit' the market should they so choose. A limited choice of 'exit' options for divesting investments often makes it difficult and some times too risky to invest in many emerging economies. In countries where local stock markets are relatively non-liquid or inactive (stock markets with annual turnover of less that $3 billion), and where stock markets are hindered by government regulatory constraints, capital gains tend to be lower than in countries with an active and liquid capital market.

Finally, in spite of short term sudden reversals of portfolio capital experienced by major emerging economies in Asia during the Asian financial crisis and by Mexico in mid-1990s, portfolio inflows are likely to continue. One reason over the long run, is that the rate of economic growth going forward remains higher in emerging markets than in developed mature economies. Another structural change has been the extremely important role of institutional investors as the dominant players in the global financial markets. These lead actors opt for optimal internationally portfolio content, so that investments are diversified across a wide range of assets, countries and regions in order to manage market and portfolio investment risks.

In the long-run there is no better antidote to the threat of portfolio capital reversals than to engage in the economic and financial liberalization and privatization and other structural reforms alluded to earlier. However, in the short and intermediate terms, central banks need to continue to accumulate foreign exchange reserves and thereby build up a 'buffer' against a sudden reversal of capital inflows.

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Endnotes

1. Huw Pill, "Portfolio Capital Flows to Emerging Markets," *Harvard Business School,* (1997), Case No. 9-796-129, p. 1.
2. See P.A. Wellons, "Cross-border lending by Citicorp in the 1980s," *Harvard Business School,* (1981), Case No. 381-146; and H. Pill, 1996, "The Recycling Problem: International Bank Lending in the 1970s" *Harvard Business School* Case (1996), No. N9-796-131
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4. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration,* (New York: Oxford University Press, 1997)
5. Michael G. Papaioannou and Geroge Tsetsekos, *Emerging Market Portfolios: Diversification and Hedging Strategies* (Chicago: Irwin Professional Publishing, 1997), p. 31.
6. International Monetary Fund, *International Capital Markets; Developments, Prospects, and Key Policy Issues* (Washington DC: IMF Publication,1997), p.27.
7. Declining interest rates in the West made the higher yielding fixed income (bond) instruments in the emerging markets more attractive. In that sense there is relationship between declining interest rates in the portfolio bond investment in the emerging markets. In the early 1990s world interest rates experienced a sustained decline, as American interest rates began to decline and reached the lowest level in 1992 since the early 1960s. Between 1990 and 1996, the average annual rate of inflation for developed countries fell from over 4 percent to 2 percent. The nominal short- and long-term interest rates fell as a result. Short-term rates declined from an average of 7.3 percent in 1987-90 to 4.3 percent in 1994-1996, and long-term rates fell from 8 percent to 6.3 percent during that same periods. For details see World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration,* (New York: Oxford University Press, 1997).
8. The global or international systemic causes, also known as 'push factors' have been address by several important studies. Notable among these are: World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1996); Eduardo Fernando-Arias, 1996, "The New Wave of Private Capital Flows: Push or Pull?", *Journal of Development Economics*, Vol. 48 (March), pp. 389-418; Guillermo Calvo, "Inflow of Capital to Developing Countries in the 1990s," *Journal of Economic Perspectives,* Vol. 10 (Spring), pp. 123-39. For a recent theoretical analysis of push factors see, "Capital Flows and the Twin Crises: The Role of Liquidity," *IMF Working Paper 97/98* (Washington; International Monetary Fund, 1998.); Piere-Richard Ageor, "The Surge in Capital Flows: Analysis of "Pull" and Push", *International Journal of Finance and Economics,* forthcoming; Peter Garber, "Managing Risks to Financial Markets from Volatile Capital Flows; The Role of Prudential Regulation", *International Journal of Finance and Economics*, Vol. 1 (July), pp. 183-95.

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9. World Investment Report 1997, *Transitional Corporations, Market Structure and Competition Policy* (New York, NY: United Nations Publications, 1997), pp. 112-113; International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (Washington DC: IMF Publications,1997), pp. 244-245.
10. Ibid. pp. 28.
11. Huw Pill, "Portfolio Capital Flows to Emerging Markets" *Harvard Business School* (August 1997), Case Study No. 9-796-129, pp. 2 –7.
12. Ibid. p. 4.
13. Ibid. pp. 30 – 31.
14. Accordingly, three dummy variables for each country for each year were constructed using the above-cited measures. By summing dummy variables and dividing the sum by the three listed measures, an index for each country for each year was obtained. The index varies between zero and one, with zero representing a complete lack of control ranging to the value of one where all three limitations exist. The limitations are restrictions on capital account transactions, use of multiple exchange rates, and rules of enforced surrender for export proceeds. The aggregate capital control index is the mean of the country indices for each year. The correlation between the index and capital inflows is –0.3 over the period shown. This study confirms the general hypothesis that there is direct positive relationship between loosening of capital controls and capital inflows to the emerging markets. See International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions*; and World Economic Outlook, 1997, also cited in IMF's study, *International Capital Markets: Developments, Prospects, and Key Policy Issues. P. 242*
15. Manuel R. Agosin, "Liberalize, but discourage short-term flows," in *Perspective on International Financial Liberalization*, United Nations Development Program, Office of Development Studies, Discussion Paper Series (New York: UNDP/ODS, 1998),p.2
16. This paragraph provides a summary of the IMF study. The IMF study is based on the annual survey of *Exchange Arrangements and Exchange Restriction*
17. *World Investment Report*, p. 114. Other relevant sources on this topic are, Mark Hallerberg, and Wiliam R. Clark, "How Should Political Scientists Measure Capital Mobility?", paper presented at the Annual Meeting of the American Political Science Association, Washington, D.C., 1997. See also, G. Garrett, and Peter Lange, "Political Responses to Interdependence: What's 'Left' for the Left?", *International Organization*, Vol. 45 (1995), pp. 549- 64.
18. International Monetary Fund, *International Capital Markets; Developments, Prospects, and Key Policy Issues.*, p. 27
19. Manuel R. Agosin, "Liberalize, but discourage short-term flows," in *Perspective on International Financial Liberalization, United Nations Development Program*, p. 2.
20. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1997).
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The Limits of Social Justice

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Egalitarians and deconstructionist multiculturalists have monopolized such symbolic slogans as "social justice." While biological, behavioral and public policy oriented empirical research has impugned many of their assumptions, there are good reasons not to anticipate a collapse of this movement in the short run. Furthermore, resistance to empirical anomalies also afflicts right of center tendencies in varying degree. Recognizing this as well as the few insights of their protagonists may enable conservatives to recapture the "social justice" high ground premised upon not only defense of one's unique cultural heritage but also by proportionately rewarding meritorious contributions to community well-being.

Key Words: Social justice, egalitarianism, deconstructionism, multiculturalism, redistributionism, libertinism

The notion that social justice, implying as it does complete equality, may be an unattainable ideal contravenes leftist beliefs. In rejecting the view that limits are inherent in the human condition, they succumb to the hubris flowing from the modern era's assumption that somewhere there is a technological or institutional fix for all problems, including "social *in*justice."

In the discussion which follows, I shall first examine the political uses and significance of this symbol for the left as well as the right. Then consideration will be given to how empirical research may temper excesses while enhancing policy cost-effectiveness. Following this I shall suggest why limits apply to what can be expected from such scientific rationality itself. Finally, a modest alternative social justice approach for conservatives will be elaborated—one that may enhance their appeal to attentive publics in a pseudo-democratic era.[2]

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[2] "Democracy" itself is, as Pareto, Mosca and Michaels argued, empirically is one of the great myths of the contemporary era. Yet as subsequent elite theorists concede, attentive and occasionally mass publics do at times on certain issues, constrain elite behavior. Such phenomena are by no means unknown in authoritarian systems.

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Political Uses and Implications

Like its functional equivalents, "equality" and "equity," social justice as a mobilizing slogan has been monopolized by the left during the past century. Indeed, antecedents such as "Equality, Liberty and Fraternity" or "Rights of Man" functioned similarly during the nineteenth and the latter eighteenth centuries.

Initially associated with the extension of political liberties to lower middle class sectors, extreme leftist use of these symbols also sought to legitimize egalitarian socioeconomic redistribution incrementally or via revolutionary expropriation. The underlying premise was that existing stratification or hierarchy was inherently unnatural, and therefore both arbitrary and oppressive.

From Rousseau's mythical "Noble Savage" to Marx's almost as imaginary "primitive communism," the romantic vision of ultimate communitarian harmony rested upon an egalitarian assumption indirectly inspired (Pearson, 1996:14-15) by the Essenes and subsequent elements of the Christian ethos. The latter affirmed the spiritual equality of all before God, and the special moral obligation of Christians to the poor and disabled. Ironically, it was the inherently atheistic or deistic (Wilson, 1998:52, 54) scientific and industrial revolution that catalyzed Christian "socialist" as well as Marxian egalitarian movements into first a major Western and then a global force.

When not converting them to welfare statism, late nineteenth and early twentieth century socialists left libertarian liberal individualists well behind in winning the support of new middle class intelligentsia and sectors of the working class. By claiming that modern productivity-enhancing technology and state control could once and for all end both poverty and class alienation, they captured the imagination of millions with a bent toward utopian perfectionism. For even more who recoiled from the repressive practices of "scientific socialism," at least welfare statism would institutionalize social justice for the victimized masses.

Thus the defection of a large sector of the liberal stream from libertarian or juridical individualism between the 1870s and the 1930s to redistributive welfare statism was paralleled by a similar mass desertion of much of the revolutionary Marxist movement to

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Ultimately, democratic normative pretensions in increasingly complex mass societies are vitiated by the paucity of civic virtue and competence on one hand, and by a lack of genuine community or shared cultural values, on the other.

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evolutionary socialism. The latter in turn progressively renounced Marxian or classical socialism in favor of welfare state (Teeple, 1995) goals during several decades preceding the Soviet Bloc Marxist revolutionary collapse.[3] Despite renunciation of state ownership of the economy, welfare statism had incorporated a commitment to egalitarian redistributionism as well as environmental determinism.

Hence, despite the apparent demise of revolutionary socialism, along with the erosion of some welfare state excesses (Gilbert, 1999) in the past decade or so, statist egalitarianism persists as a major Western political force. In the East, salient socialist factions and parties – sometimes in an uneasy coalition with populist nationalists – are challenging many if not all successor liberal regimes. In the West where the globalization of capital has diminished state resources, the left has targeted middle class sectors for redistributive measures to promote "equity" for the poor and various "multicultural" ascriptive groups such as minorities, immigrants and women who are reputedly oppressed by racism and patriarchy.[4]

This shift in focus since the 1970s increasingly resembles the multiculturalist strife in the South, where group preferences have been sought by self-seeking elites upon behalf of less advanced ethnic, racial or religious sectors. The consequential internecine violence (Sowell, 1996) in those regions – often rationalized in social justice terms – is being mirrored in the West by accelerating intergroup tensions and a weak but slowly growing reaction amongst socio-cultural conservative and populist national movements in Europe and America.

Thus "social justice" in recent decades has been operationally redefined to rationalize redistribution and group preferences for all "disadvantaged" who are arbitrarily categorized as "oppressed" by

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[3] The welfare statist convergence of both the socialist and liberal dominant tendencies involved a consensus to subordinate individual liberties to egalitarian collectivist entitlements, as well as an ever more intense liberal embrace of socialist *internationalism* since the 1870s. Yet as the reformist socialists evolved toward social democracy or welfare state liberalism, they gradually acquiesced to liberal free trade policies which ironically freed international capital from state leverage. This de-coupling ultimately undermined the welfare state itself.

[4] Liberal and Social Democratic aversion to nationalism in their own societies is paralleled by their unqualified endorsement of Third World nationalist claims against the largely white "exploiting" industrialized societies. This double standard is premised upon biological egalitarian assumptions, and functions to alienate the left from majorities in their own countries.

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national traditions, culture and institutions. In postmodern terms, national communities are portrayed as little more than manifestations of arbitrary power by historically dominant ethnic groups. As such, they have become objects of deconstruction by ascendant multi-culturalist elites whose constituencies are infused by an invasion of Third World immigrants. Hence the class struggle against capital has been transformed into one against the successful by those who envy such attainments, whether cultural or material.[5]

The Relevance of Empirical Research

As Pearson (1996:56-89) and others have stressed, there has been a pervasive egalitarian – now supplemented by (Wilson, 1998:58) multiculturalist – bias in both the humanities and social sciences. When empirical data contravene egalitarian assumptions, it is ignored, denigrated, misinterpreted or otherwise impugned. Ubiquitous arbitrary discrimination in journal access is mirrored in such areas as academic recruitment, promotion and research grants by major foundations or government entities. This because of a tacit and occasionally explicit dedication by Liberals, Social Democrats or other leftists to "social justice" or "equity." To the foregoing may be added the fashionable code word "diversity" (Thibodaux, 1994; Wierner and Berley, 1999).

Notwithstanding such virulent opposition, empirical data on the very limited and often costly successes or outright failures of socialist and welfare state projects has been accumulating to the point where moderate numbers of erstwhile leftists are defecting while the mood of mass publics has become more skeptical and even hostile to group preference and other entitlement excesses. Similarly, the persistence of socio-economic as well as political stratification, low productivity as well as the major shortcomings of "proletarian democracy" in Soviet style regimes has been widely documented.[6] Put differently, egalitarian ideological constraints were either contradicted in practice or contributed to reduced effectiveness (Codevilla, 1997:79-98) of systemic

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[5] Since cultural (Sowell, 1998) and/or biological (Pearson, 1996) superiority cannot be reconciled with egalitarian dogmatism, only power, privilege and oppression are deemed to explain contemporary stratification.

[6] Thus, as von Kuehnelt-Leddikn (199:16) notes: "[s]ince 1989, leftism has largely abandoned state capitalism [socialism] and has been more lenient toward private enterprise, but it has also sped up its march toward Gomorrah."

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incentive structures.

Empirically demonstrated failures also have characterized the Third World, optimistically if not euphemistically know today as "the developing nations". Hundreds of billions in foreign aid, investments and educational assistance have failed to spark developmental mobilization or success in most of the Third World. With few exceptions, internecine conflict, mass impoverishment and malaise continue to characterize much of that region.[7] Indeed, those who can flee in ever greater numbers to the more successful cultures of the North. Can the latter be as socially unjust, racist and sexist as our indigenous deconstructionists allege?

In fact, evidence in our own Western societies is accumulating on the dysfunctional effects of welfare programs as well as Liberal crime, educational, housing and employment policies.[8] Ones that are now aggravated by thinly veiled illegal group preferences favoring those of inferior talents. Such policies not only undermine productive incentives and civility, but they entail a cost ineffective waste of scarce economic resources. Indeed, a vast and proliferating politically active bureaucratic stratum has emerged administering and elaborating often arbitrary regulations.

These multiple failures of the egalitarian paradigm suggest two conclusions. First, the fiat of the state cannot transform unequals into the opposite. Differences in virtue, aptitudes, talents and motivation inhere in the human condition. Even in early childhood, intervention yields but modest and frequently short lived behavioral modification. To promote equal protection or rights before the law – a distinctive Anglo-Saxon and American jurisprudential ideal – is one thing.[9] But to expect that social engineering can render biological differences

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[7] Ironically, the region least penetrated by Western colonialism—sub Saharan Africa—symbolizes the greatest developmental failure. The one major exception, South Africa, is now also in sharp decline economically, legally and democratically.

[8] See, for example: Bolick (1996); Briggs (1998); Clegg (1998); Codevilla (1997); Collier and Horowitz (1997); D'Souza (1995); Fallon (1998); Farrell (1994); Frankel Paul (1988); Gross (1997); Hoff-Sommers (1994); Jakras (1998); Kelley (1998); Kors and Silvergate (1998); Lal (1997); Levin (1997); Lynch (1992); Rushton (1995); Schmidt (1997); Schoeck (1987); Scott (1998); Sowell (1993; 1995; 1995a; 1996; 1998); Steele (1998); Taylor (1992); Thernstrom (1997); Thibodaux (1994); Watkins (1996); Weissberg (1998); Whitehead (1997); Zelnick (1996).

[9] Even here, as Bernstein (1994) and Ellis (1998) underscore, the rule of law itself is being attenuated by the multicultural drive for "special [group] rights" or entitlements.

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nugatory is quite another.

In fact, this zealous drive generates practices which undermine the rule of law by creating group preferences and concomitant "special rights." These in turn systematically reward inferior productivity and community contributions whether in educational or occupational areas. As they proliferate, the society degenerates into warring ascriptive groups where power rather than social justice determines short-term distributive entitlements and outcomes.[10]

Here too the growing corpus of biological research on race and ethnicity [as well as gender] cited by Hoff-Sommers (1994) and Pearson (1996) suggests a second conclusion. In brief, the underlying biological assumption of egalitarians is faulty. Their failure to recognize that some groups – sexual, racial and ethno-cultural or national — may be superior in certain respects while inferior in others is and will become an ever more glaring empirical deficiency. This, in part, has contributed to the previously mentioned cost-ineffectiveness or relative failure of many though not all welfare statist and socialist programs. It also explains why class or ascriptively targeted group preference policies tend to arbitrarily reward performance inequality without substantially altering the latter.

The Limits of Empiricism

Ironically, empirical research itself suggests that the denouement of our endeavor may be problematic if not hopeless. Two findings confront us: the ubiquity of mammalian and human stratification as well as the paramountcy of kin or other group affinities. Thus we can better understand why despite the accumulation of empirical anomalies (Kuhn, 1970) in the egalitarian and multicultural paradigms, upper middle class elites which value secure power and perquisites tenaciously deny or ignore such evidence. Their positional ambitions are simultaneously reinforced by class, racial, ethnic and sexual vicarious affinities with "the oppressed." These in turn provide them with spiritual meaning.

Thus, here we see psychology is also in accord with traditional conservative emphasis upon the limits of reason and moral

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[10] The claim that such entitlements as group preferences are "compensatory," is not only devoid of empirical basis but it also—in appealing to blood guilt ancestral rationales—reinforces ascriptive polarization thus further attenuating the significance of achievement merit as a distributive norm.

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perfectionism. While positive and negative eugenic policies might reduce the ubiquity of perversity and even inequality in the distant future, our social environment in the decades ahead is likely to be characterized by leftist elite militancy rejecting such policies and favoring quasi-violent ascriptive zero-sum conflicts for "social justice." Thus is explained the pattern of empirical intolerance so widespread even in academia during recent decades (Pearson, 1993) is unlikely to abate.

But we too should recognize that beneath our own scientific pretensions and apparent universalism, primordial group loyalties as well as paradigmatic rigidities also are operative. Modern science is distinctively a Western contribution as is the rule of law, etc. Thus underlying this heritage are ethno-cultural and even racial sources of identity (Francis, 1999) that powerfully reinforce our character and pride. As a source of distinctive behavioral tendencies (Pearson, 1996) and cultural practices, they are integral to community itself. Indeed, like Francis, Gottfried (1999:19) views such ethno-cultural homogeneity as essential to effective or viable democracy as did Aristotle, Rousseau, and Jefferson.

We too tend to resist empirical data indicating that free markets may not (Gray, 1998) in all respects be either "free" or benign. Even for the meritorious! That equality before the law may be more nominal than real for some societal losers, and that inferior groups may not be uniformly so. Not only Orientals such as the Koreans or Japanese, but other groups may exhibit certain superiorities vis a vis white males or Euro-Americans.

Those who oppose these prevailing trends need to recognize with humility that if they controlled the media, academia and research funding, their decisions might not be wholly immune from ideological or group-affinity constraints. Indeed, neutral principles of law or liberty are more facilely verbalized than operationalized. Neither definitions of "news that's fit to print" nor what deserves to be empirically investigated are unaffected by value judgements. Is there not some inherent tension between scientific universalism and particularistic conservative loyalities?

Hence, our own primordial and spiritual meanings may also constitute hindrances to empirical advance toward a more functional, productive and harmonious social order. A degree of humility, reinforced by Aristotlean "moderation" should temper our quasi-instinctive commitments to the unqualified superiority of our

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ethno-cultural heritage and national cultures. Only then will we be able to mount a credible and effective challenge to the "multicultural" Jacobin militants who have infiltrated our churches, schools, media and governments. How well we can surpass the dogmatic empirical hostility of the left remains to be seen.[11]

Is There an Alternative?

What kind of "alternative" should this be? As Wilson (1998:52-54; 1998a:67-69) himself has conceded, reason, scientific rationality and empiricism per se are not adequate sources of meaning for most of us. From a scientific standpoint, we are not too far evolved from a stage wherein most of mankind has a genetically programmed need for transcendent spiritual loyalties — vertical and/or horizontal — to provide meaning for our lives. This explains the innate or instinctive appeals of not only hierarchy and community but also egalitarianism.

Admittedly, the latter have monopolized yet do not have title to social justice as a concept. Those of more conservative tradition have associated it with "giving each his due." That too when operationalized in terms of merit and community enhancement also resonates powerfully among those whose point of reference is the Western heritage.

Yet in specifying norms derived from this conceptual approach, we should avoid simplistic dichotemies. Just as our ethno-cultural and ideological commitments should be tempered by empirical advances, so too should we approach the apparent contradiction between relativism and absolutism. Western values are but one of the extant world's traditions. Yet they are natural and probably in most respects best for us if modern history means anything.

Our confidence in this is empirically consistent with the quasi-universalistic appeal and influence (Zachary, 1999) of Westernization.[12] If our socio-economic and cultural achievements are

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[11] Perhaps marked superiority vis a vis egalitarians on this point is neither necessary nor desirable. Cold empirical inclinations appeal to but a few. Beliefs, myths and ideals have been and remain as primary sources of emotional inspiration for most of us.

[12] At least at a superficial level, much of the south and East are in a headlong rush to adopt (Zachary, 1999) Western styles, accoutrements and even attitudes. Put differently, Islamic and other traditionalist. as well as residual egalitarian forces are fighting a rear guard defensive campaign for their peoples' hearts and minds. Postmodern group preference multiculturalist have more in common with Islamic and other traditionalists than with the remaining "scientific socialists." This despite the former's ubiquitous invocation

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not on balance superior – as post modern deconstructionists allege – why are the migratory multitudes from less successful or failed (Sowell, 1998) non-Western cultures "voting" with so many feet to negate or subvert our immigration controls?[13]

What then of social justice? Here it is crucial to avoid the extremism of our protagonists. The criteria for promotion, status and distributive rewards as well as reproductive incentives should recognize individual as well as group (e.g., medicine or military) contributions to community well-being.[14] Integral to this are the principles of merit or excellence, *proportionality*, and moderation as underscored since the times of Aristotle and more recently by Sowell (1996; 1998) and Codevilla (1997).

But there is a competing Jacobin Marxian Western tradition that empirically is for the most part deficient in terms of its biological assumptions. Yet, as with its symbiotic twin "Democracy," the myth of "Equality" may contain a grain of truth.

By recognizing rather than categorically denying this, a more effective and even successful philosophical tradition can be reborn. Put differently, those who eschew the implications of egalitarian concepts of social justice should transcend any knee-jerk reaction against, and psychological closure toward, egalitarianism so as to better assimilate insights that must characterize any movement that has developed such appeal in the past century or so.

What are these? First, that while capitalism has tended to benefit society and reward merit, it does not invariably and in all respects engender such outcomes. Mass layoffs involving tens of thousands in both salaried and wage earning sectors often if not always have little to do with the merit of individual employees. Put differently, from the

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of egalitarian ideological rationales.

[13] Between ten and fifteen million are now legally or often illegally lodged within Western societies. Given the demographic magnitude of this "invasion," there are serious concerns over whether they can or should be assimilated. The former is exacerbated by growing multicultural and deconstructionist movements hostile to the historic ethno-cultural traditions of Western societies in which they reside. On these tendencies, see: Brimelow (1995); Beck (1996); and Fallon (1998).

[14] How the "community" is defined is of course a matter of controversy. But as Francis (1999) argues, the most reasonable approach course would be to prefer historical natural ones which have stood the test of time, notwithstanding temporal evolution. Empirically, the record of the last century indicates the difficulty of artificially structuring new communities of shared memories, culture and rapport by state fiat.

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standpoint of social justice, some "losers" are not at fault. They, as fellow members of our communities, deserve compassionate treatment and distributive assistance, i.e., they do have merit.

This should not be confused with egalitarianism (Gottfried, 1999) which indiscriminately claims that all losers and anti-social elements are equally or more meritorious then elites who benefit from oppressive institutions. Nor with its pseudo-egalitarian anti-European "multiculturalist" cousin which zealously seeks group preferences on the basis of sex, gender, ethnicity or race. Neither of these militantly collectivist movements give salience to or even acknowledge such values as individual liberty, genetic diversity, or the rule of law.

Yet, in a complex technological corporate (i.e., collectivist) society, doctrinaire libertarianism is antithetical to social justice. There are macro-economic, foreign trade, environmental, anti-trust and consumer issues that of necessity require limited, preferably non- coercive, governmental regulation if any semblance of a genuine community based upon human dignity is to be maintained. This in part is integral to Pat Buchanan's (1968) critique of laissez faire trade and immigration policies.

In other words, without undermining productive incentives or merit based reward structures, distributive and regulatory policies should ensure support for those meritorious individuals or groups which are through no fault of their own disadvantaged temporarily. This should be an elite responsibility which will—along with policies that strengthen (Codevilla, 1997) families, churches and localities—reduce alienation and begin to rebuild a *national* community.[15]

At the same time, it must be recognized that some receive considerably more than is their due. It is not only affirmative action "group preferences" that bureaucratically and juridically undermine incentives as well as the rule of law which is a *sine quo non* for genuine community, but also some extravagantly remunerated members of the

[15] Merely because the left has unduly proliferated "rights" as claims upon others and grossly abused the welfare state to generate entitlements based dependency is no reason to throw the baby out with the bathwater. Structural reform rather than extremist rejection is the appropriate approach in an industrial society no longer based upon yeoman farmers.

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corporate, professional and entertainment elites.[16]

The bonds of community are eroded by excessive as opposed to moderate inequality.[17] Particularly when the former, as Rawls argues, is unrelated to significant societal benefits on one hand, and constrains downward as well as upward mobility on the other.

Again, Aristotlean moderation implies the need for limited, minimally coercive regulation as it does in other areas of harmful individual and social excess such as abortions, divorce upon demand, gambling, drugs, pollution, etc.[18] Confusing libertinism with libertarianism can easily contribute to the decadence and decline of our civilization. Liberty is protected by a community in all cases, and must not be used in a manner that subverts (Weissberg, 1998) its source.

Because pseudo-egalitarians (Lasch, 1995; Watson, 1999) have fomented excessive regulations, often intrusive or egalitarian in nature, and a proliferation of widely abused "rights," there is, as suggested earlier, no reason to dispose of the baby with the bathwater. Reform rather than reactive libertarian extremism offers the best prospect for reviving a sound social and political outlook on the world, i.e., a sense of *noblesse oblige.*

Finally, there is the question of undeserving losers or "disadvantaged." Modern society is literally plagued by soaring numbers of persons deficient in civic responsibility and motivation to take advantage of available opportunities. These "social parasites" threaten and burden rather than contribute to community well-being. Many deserve their fate without the benefit of any entitlements or even temporary assistance paid for by productive citizens. Yet, we must

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[16] Buchanan (1998:9) for example points to a level of disparity that distinguishes the U.S. from counterpart industrial systems: "[t]op CEO salaries—44 times the average wage of a worker in 1965—have soared to 212 times the average pay of a worker."

[17] Reasonable men may differ over operationalizing "moderate" to limit excessive inequality. Modest contributions by diligent semi-skilled strata should be sufficiently rewarded that a partially *shared* "way of life" exists. Otherwise the very term "community" rings hollow and systemic legitimacy is rendered problematic.

[18] Left to itself, a completely autonomous market will generate supply at a price for these and other activities which can damage or destroy a community and its citizens "quality of life." Limited regulations by an "energetic" state, to use Alexander Hamilton's term, can influence *rather* then supplant market incentives. Some activities that are deemed especially injurious such as late-term abortions or high stakes gambling may not (Weissberg, 1988) be tolerated despite a growing market for them. In other words, while individual liberty is precious and should be expanded, there are situations when it must be balanced against community well-being, i.e., its adverse effects upon others.

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recognize that both the present penal system and criminality also impose heavy costs upon others. So does their mere presence, as proponents of the death penalty are not slow to point out.

Here a multipronged approach emphasizing assisted emigration, very restrictive immigration, and negative eugenic incentives might be considered along with self-supporting labor-intensive penal institutions for "hard core" elements. Private sector charitable organizations should be encouraged to provide minimum needs for those not irreversibly anti-social.

Whether such elements and particularly those who do not acquire minimal civic competence deserve full citizenship rights is another question deserving serious concern.[19] If merit and contributions are to govern distribution and status, why exclude civic rights from consideration?

Some conservative theorists (von Kuehnelt-Leddihn, 1999:15) regard unqualified majoritarian "democracy" itself as inconsistent with the principle of merit, and as a system inherently likely to vitiate such ethical norms. Similar reasoning is used by Gottfried (1999:20) to justify exclusion of groups with antithetical ethno-cultural values and attitudes.

If social justice involves due process and proportionate distributive rewards for community enhancement qualified by compassionate assistance in cases of fortuitous misfortune, why was the term "limits" used in this paper's title? Here the problems transcend those of conservativism vs leftist hubris and utopianism.

Politically, the bonds of communitarian identity in many Western societies have already been rendered problematic. Regardless of differential contributions, vested interests in group entitlements as a matter of "rights," are ubiquitously defended. Among all classes there is intense resistance to change notwithstanding impending state bankruptcy. How will anyone persuade voting students with limited academic aptitude that no community benefits justify their Pell Grants?

Those who strive to resist leftist proselytizing need to be sensitive to human inequalities with respect to both rationality and virtue. Multitudes with average or subnormal character and intelligence are unlikely to understand or otherwise respond to a more sober vision of change toward a meritorious social order.

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[19]Those who fail to accept obligations and responsibilities to others have no claims upon community-derived rights beyond those associated with due process. Indeed, they may be excluded from the national community.

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Beyond that are empirical problems of measurement and implementation. It is not simply a matter of measuring and comparing or weighting differential contributions. Inevitably imperfect answers will also govern how much inequality should be tolerated without sacrificing reasonable opportunities for lower income offspring. Conversely, how much should successful families be justly taxed without vitiating their incentives? To what degree are" disadvantaged" groups responsible for their situation? Similar empirical questions pertain to the limits of state regulation. Answers to such questions will be tentative and imperfect requiring constant readjustment.

While the foregoing provides only a guide – certainly not a panacea – for addressing the egalitarian juggernaut, it does offer an invariably moderate vision of an alternative social justice approach which can modestly strengthen rather than attenuate the ties that give cohesion and meaning to any community. Even with inevitably imperfect operationalization, it can be a source of hope that may help us transcend the contemporary state of despair.

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BOOK REVIEWS

Why Smart People Make Big Money Mistakes – and How to Correct Them: Lessons from the New Science of Behavioral Economics
Gary Belsky and Thomas Gilovich
Simon & Schuster 1999

In this book, Gary Belsky and Thomas Gilovich apply behavioral principles from psychology to finance. As often happens, one author is an academic and the other a journalist. Gilovich is a Cornell psychology professor and author of a book on the fallibility of human judgment (Gilovich, 1993). Belsky is an ex-Money Magazine financial writer. What these authors call behavioral economics is what other authors call behavioral finance. It recognizes that people are not the perfectly rational, perfectly informed investors assumed in standard financial economics theory. Instead they are subject to a long list of biases.

One interesting bias deals with failure to utilize base rate data. The topic is introduced by giving a brief description of someone who is quiet and reserved, and then asking whether the man is more likely to be a librarian or a salesman. Since the characteristics described are those of the stereotypical librarian, most people guess he is a librarian. Yet the correct answer is salesman. Why? Because there are so many more salesmen in the economy than librarians. Even allowing for this personality type to be over represented among librarians, in total more of the people with this personality type end up as salesmen than as librarians.

A number of books on behavioral finance or economics have described this effect using versions of the above example. Yet there is a parallel literature on racial and sexual prejudice where it is asserted to be factually wrong to take base rate information into account (and also morally wrong). As has been shown in this journal (Miller 1994) and elsewhere (Miller 1980), base rate information logically should be used in making personnel decisions.

Needless to say, this book, like others on behavioral finance, fails to point out the conflict of its discussion with the mathematically similar literature on stereotyping.

An illustration of failure to consider base rates occurs in sports.

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Studies show that the probability of a basketball player sinking his next basket is best approximated by his longer term average performance, not how he has done earlier in the game. Hence, the best strategy is to use the player who has the best long run average, even if he has missed his last few shots. However, there is a widespread belief in "hot hands", and most fans, coaches, and player believe the player to use is one who has recently done best. This mistake seems to arise from people not appreciating how even in a random series of events there will be runs.

One implication for investors deals with mutual funds. At any given time mutual fund performance over the last year or years exhibits much variation. However studies have repeatedly shown that most of this variability is due to random factors. In the future the historically best performing funds are unlikely to do much better than average. In spite of this, investors consistently seek out the funds that have done best in the recent past, and just as consistently are disappointed.

Likewise, investors appear to give too little weight to base rates in estimating company profits. They are thus surprised when regression to the mean occurs, and previously extraordinarily profitable firms earn only normal profits. This regression to the mean is frequently accompanied by a sharp decline in the stock price.

Humans exhibit regret aversion. They suffer heavily from having to admit (even to themselves) to having made a mistake. As a result investors are very reluctant to sell a stock for less than they paid for it. Instead, when they have a loss they frequently refrain from taking the loss. The intention is to hold the stock until it has risen to the price it was bought it at. In contrast they will frequently sell a stock that has gone up in order to lock in a profit. Actually, because of the tax deductibility of losses investors would do best to readily sell their losses while holding their winners.

Psychological studies have consistently shown people are overconfident regarding their own ability. Ninety percent of Swedish drivers claim to be above average. As a result most individual investors think they can beat the market. Yet if one thinks a moment one will realize that the dollar weighted performance of all investors will be the market. With a large fraction of funds managed by institutions employing full time experts, it would seem plausible that an individual investor would be at a disadvantage. Yet a large number of investors persist in believing that they can beat the market. Many of these believe they can profitably trade in and out of stocks, in spite of the costs of trading and the tax liabilities such short term trading incurs.

The failure of such strategies is shown by a study by Odean and

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Barber, who obtained access to the trading records of a discount brokerage. While the average investor slightly beat the 17.1% S&P average gain for the same period, the 20% of the investors who did the most trading earned an annual return of just 10%. Another piece of Odean's research reported elsewhere in the book showed that the average trade shifted out of a stock that subsequently did better than the stock shifted into by 3.4%.

The average stock mutual fund earned 12.3% from 1984 to 1995, and the average bond fund earned 9.7% (p.178). However, over the same period the average investor in stock mutual funds earned 6.3%, while the average investor in a bond mutual fund earned 8%. Why the difference? There were a lot fewer investors in a mutual fund before it performed well than were in it before it performed poorly. This is because a fund often does best when it is small and has relatively few investors. However, if it outperforms it attracts many more investors. Since unusually good performance is typically followed by average or worse performance, these investors find they have bought in just before a period of average performance or worse.

As an example they use PBHG Core Growth, which had 31 million dollars in assets at the end of March 1996, when it had just returned a spectacular 18.2% for the previous quarter (when the S&P index returned only 5.4%). Not surprisingly, these returns led to a flood of new money that added more than 200 million dollars to its assets in May and June. However, these new investors were exposed to the fund's 3.8% loss in the next six months. The result was that over 1996 the fund was up over 32%, but the average investor lost 3%. Why? Very few of investors were in the fund when it had its spectacular performance. However, this performance attracted a large number of new investors. These investors then lost money when the fund had its down period.

The authors offer no explanation for the tendency of people to be overconfident. However evolutionary psychology offers an explanation. Part of reproductive success is mate acquisition, especially for males. To some extend we judge people by what they think of themselves, and whether they act as if they have what it takes to succeed. A certain degree of self-confidence aids in acquiring a high quality mate. That makes the contribution of self-confidence to reproductive success positive, even if it does sometimes lead to bad decisions.

Also, males (who do most of the investing) benefit reproductively from taking risks, and excessive self confidence is how they are programmed to take the risks that often paid off in multiple mates and

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many descendants.

The book is aimed at a popular audience. After discussing each of the sources of bias, it offers advice on avoiding that bias. It is plausible that knowing the biases to which we are vulnerable will help us avoid mistakes in our financial decision-making.

One problem with this book for the academic reader is that it lacks references (and an index). However since the authors for the major studies discussed are named, the citations for the original articles could be obtained by a search of databases such as Psychological Abstracts. Shefrin (2000) covers much of the same materials at greater length and detail for the finance professional.

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MAGIC: The Untold Story of U.S. Intelligence and the Evacuation of Japanese Residents from the West Coast During WW II
David D. Lowman
Athena Press, Inc., 2000

David D. Lowman retired as Special Assistant to the Director of the National Security Agency after a career as an intelligence officer, during which he received the Exceptional Civilian Service Medal, the NSA's highest award. He was a major witness before the congressional

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committees that in the early 1980s reviewed the history of the American evacuation of the Japanese-American population from the West Coast during World War II.

This book is, in its principal dimension, a compendium of the intelligence information that lay behind the Roosevelt administration's decision to order the evacuation. "MAGIC" was the designation given to the United States' breaking of the Japanese diplomatic and espionage codes and ciphers in 1940 – a feat of the highest magnitude, since it not only helped immensely against the Japanese, but also enabled the United States to keep abreast of the highest-level planning within Nazi Germany, as that planning was conveyed to Tokyo throughout the war by the Japanese ambassador to Germany.

In addition to the MAGIC diplomatic cables, known to only a select few at the top of the administration, there was much additional information gathered through the more ordinary intelligence processes. Lowman provides copies of the pertinent Japanese cables and U.S. intelligence reports, making this a source-book of considerable value.

While the book is almost entirely informative rather than argumentative, it is motivated by a profound anger over the disinformation given to the American people since the 1960s about the evacuation. (Most Americans have been given to believe that 112,000 patriotic Japanese-Americans were "interned" in "concentration camps" during the war.) Lowman considers that "the failure of the U.S. government to present the facts involved in the wartime decision to evacuate the Japanese and to defend the honor of our country and its wartime leaders is nothing short of an outrage."

He points to an on-going phenomenon: the funding of "public indoctrination which portrays a flawed accounting of actions taken in the urgency of war." $50 million was set aside at the federal level for that purpose, and Lowman tells us that "California presently appropriates millions of dollars in support of the 'official' history of Japanese evacuation." Such continued funding of a skewed telling of history by federal and state governments and by tax-exempt organizations, all propelled by politics and ideology, exacerbates a problem that in lesser forms has long bedeviled serious scholars. When prior generations, for example, have enshrined specific and often highly partisan perceptions in monuments, cemeteries, and public commemorations of all kinds, they have promoted a certain "received history." That version has then become the mythology of the age that has followed.

A question for Americans today is just why they would wish to

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perpetuate an alienated mythology about the relocation of the Japanese-Americans. This isn't the place, however, to review that issue in its entirety; the author of this review did that in a lengthy article on the subject in the Spring 1993 issue of this *Journal*.

Within the scope of this review, it will be most helpful to highlight certain specifics:

1. The evacuation was not to internment camps but first to assembly centers and then to relocation camps. Approximately 30,000 chose to move away from the camps during the war, taking jobs in cities in the central and eastern United States, while the rest decided to remain. An actual internment camp did have to be set up at Tule Lake for those evacuees who were militantly pro-Japanese (and to house their wives and children, since the policy was not to split families).

2. Following legislation in 1948, the United States paid some $37 million to settle claims for property losses incurred by the evacuees.

3. In the 1960s, militants began agitating for "reparations." That bore fruit in the 1980s with the creation of the Commission on Wartime Relocation and Internment of Civilians. The hearings of this Commission were almost unbelievably political and ideological. John J. McCloy, who had been Assistant Secretary of War during the relevant period, was a witness before the Commission, and later wrote that "From my personal appearance,...I believe its conduct was a horrendous affront to our tradition for fair and objective hearings... Whenever I sought in the slightest degree to justify the action of the United States which was ordered by President Roosevelt, my testimony was met with hisses and boos [from the spectators]... Others had similar experiences." One of these was Karl R. Bendetsen, the military officer in charge of the initial evacuation; the booing and hissing prevented him from presenting his full testimony. He said "I knew it would be fruitless. Every commissioner had made up his mind before he was appointed."

4. The "reparations" called for by the Commission eventually cost $1.6 billion. $20,000 was paid to each of the evacuees. These included the 4,300 who attended college at a number of American universities during the war, the 30,000 who resettled in the central and eastern United States, the 4,724 who voluntarily returned to Japan, the almost 10,000 who refused to sign an oath of loyalty to the United States, those who while in the camps "engaged in semi-military drilling and in Japanese patriotic exercises to the sound of bugles," the 6,000 who were babies born in the camps, the enemy aliens (not Japanese-Americans) who had been locked up in Department of Justice camps as security risks right after Pearl Harbor, and even the several hundred people who had

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been sent to the United States from Latin America as security risks. Twenty-nine people declined to accept the $20,000.

5. The relocation was not unique to the United States. "The British removed all people of Japanese ancestry from Singapore, sending them to India." In early 1942, "Mexico removed all of its Japanese residents from Lower California and away from the coastal areas of continental Mexico." At the same time, "the Canadian government began relocating the 20,096 people of Japanese ancestry from its West Coast in British Columbia." Interestingly, Canada didn't permit them to return to the West Coast until 1949, four years after the end of the war.

6. Lowman tells how "in China, Hong Kong, and Southeast Asia the resident Japanese had sided completely with the attacking Japanese armed forces. Moreover, the conquering troops treated all resident Japanese as reunited brethren... In the Philippines there were about 30,000 Japanese residents on Mindanao Island alone, almost all of whom appeared to have completely gone over to the invaders...." U.S. Naval Intelligence reports dated January 26, 1942, give the detail about how after the attack on Pearl Harbor a Japanese fighter plane crash-landed on the Hawaiian island of Niihau, where the pilot and two resident Japanese (one of whom was a Japanese-American) held the islanders captive until December 13, at which time the siege was broken when the pilot was killed and the Japanese-American committed suicide.

7. The Japanese cables revealed an established plan to use "second generation" Japanese for intelligence-gathering in the United States. A cable from Tokyo to Washington on January 30, 1941, said that "in view of the fact that if there is any slip in this phase, our people in the U. S. will be subjected to considerable persecution, the utmost caution must be exercised." A cable from Los Angeles on May 9, 1941, informed Tokyo that "we shall maintain connection with our second generations who are at present in the (U.S.) Army, to keep us informed of various developments in the Army. We also have connections with our second generations working in airplane plants for intelligence purposes." Cables in August and September of 1941 reported specifics about the cargo of an American ship and about aircraft production in the factories of southern California. An American intelligence report on January 21, 1942, said that "their espionage net containing Japanese aliens, first and second generation Japanese and other nationals is now thoroughly organized and working underground."

Necessarily, the book contains much more. It takes its place as a major contribution to the literature on the subject, and should be

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available to everyone studying the issue.

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Irrational Exuberance
Robert J. Schiller
Princeton: Princeton University Press, 2000

Irrational exuberance (Princeton: Princeton University Press, 2000) is Yale professor Robert J. Shiller's discussion of the current level of US stock prices. He uses this book to argue that they are far higher than can be justified by fundamental conditions. He suggests that we are in far either a severe decline, or at least a long period of relatively low returns. Such a decline may have already started in 2001, since the market has declined severely this year. The book is thus a counter to Siegel's (1998) "Stocks for the Long Run" (recently reviewed in this journal, see Miller 2000), which argued for investing money intended for the long run (such as retirement) in stocks.

Some of the most persuasive points in the book are made through graphs. His first figure shows real (i.e. adjusted for the price level) stock prices, 1871-2000, and earnings. Earnings fluctuate some but show an overall steady growth. However stocks fluctuate much more rising to a peak in 1929, then another peak in the sixties, and then shooting in what looks like a straight line upwards. The book's second graph shows the price earnings ratio for the same period. It is clear that this ratio has had four major peaks, ones in 1901, 1929, 1966, and then 2000, with the level in 2000 far exceeding any observed prior to that time. The essence of Shiller's argument is that there is no compelling reason for the current high level of stock prices, and that they could very well come back down as historically high prices had done before. His third diagram is a scatter plot of total returns after ten years versus the price earnings ratio. It shows an unmistakable tendency for years of high price earnings to be followed by below normal returns. While there is no historical precedent for current levels of price-earnings ratios, extrapolating the curve shows real returns from investing at current prices could be substantially negative.

Shiller discusses why stock prices are so high but offers no convincing reasons for them to be so high, or even reason why they are so high. He suggests strongly we are in a "speculative bubble" in which

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investors notice prices have been rising and buy expecting the trend to continue.

Part of the blame for the current high prices (and for any future collapse) goes to modern financial theory. The mainstream theory (taught in all the textbooks) is the "efficient market" theory, which holds that security prices fully and correctly reflect all available information. This theory implies that prices follow a random walk with a drift. They fluctuate but do move upwards over time. The theory provides no firm rationale for the absolute level of prices. Presumably one who believes in the theory would estimate the long run returns on stocks from the historical record. Since this historical return far exceeds that of bonds and bank deposits, the logic would seem to imply that savings should be invested in the market, and that this should be done without trying to determine whether stocks are too high or too low. Investors can (and should it is argued) free load on the evaluative efforts of those who do the tedious work of valuing assets.

Yet theoreticians have long been aware that everyone cannot "free load". Someone must be trading on information if prices are to reflect the available information. Schiller makes a fairly compelling case that virtually no one is looking at the overall level of stock prices and asking if they are too high. Mainstream theory gives relatively little guidance. Prices in theory should be the present value of future dividends. However to calculate present value one must know the discount rate. Theory merely argues that this should be equal to the nominal risk free rates plus a risk premium but gives little guidance to what the risk premium should be. The historically observed risk premium appears higher than can easily be justified as Siegel and others have pointed out, but it is not clear what the correct value for the risk premium should be. This means that there is no generally agreed anchor for the risk premium, and hence for the required return on stocks. Most of the major fluctuations in stock prices could be explained (i.e. rationalized) as changes in the risk premiums.

Dividends change relatively little year-to-year, growing at a relatively steady rate. In theory, stock values and stock prices are the present value of all future dividends. In such a standard model, the prices of stocks should fluctuate less than the dividends themselves. Yet, in a very striking diagram (p 186) Schiller shows the real value of stock prices versus dividends. The dividend line rises steadily, but the price line looks like a mountain range. It is obvious that something is

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inconsistent with standard efficient market theory. It is these fluctuations in the risk premium that themselves constitute the major risk in holding a diversified portfolio of stocks. Indeed, investor dislike for this risk (that traces to a fluctuating risk premium) is probably a major cause of the risk premium itself.

Of course we are now in the era of the "new economy" from whence there will be unprecedented prosperity. Alas, a historical review shows that previous periods of high prices (peaking in 1901, 1929, and 1966) have been accompanied by similar pronouncements. What about the public finally recognizing that stocks have historically yielded more than bonds for those who bought and held them for the long run, in the manner that Siegel's Stocks for the Long Run urged? (again see Miller 2000 for a review and summary of this book) Alas, similar books with documentation were published in the 1929 boom. One of the more valuable parts of this book is the account of historical episodes of US high stock prices, and a whole chapter devoted to the greatest rises and falls of various worldwide markets. As an interesting piece of trivia, the largest one-year increase in any stock market was an incredible 683.4% for December 1985 to December 1986 in the Philippines.

However, in spite of the occasional impressive return the basic lesson of the book is that stock prices fluctuate, stocks are risky, and we are probably much closer to a long run peak (which it appears occurred in 2000) than to a low. Investors be warned.

Edward M. Miller

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